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college of commerce & management

**BBA/B.Com/ B.Com (Hons)/BAJMC/ I<sup>st</sup> Year Subject-Financial Services & Insurance**

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## **SYLLABUS**

**Class: - I Year**

**Subject: - Financial Services & Insurance**

| <b>Units</b> | <b>Syllabus</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|--------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| UNIT – I     | <b>Overview of Financial Services</b><br>Meaning, Importance and Scope of financial services, Indian financial system, Brief Study of Financial Institutions - RBI, Commercial and Co-Operative Banks, Non banking financial institutions, Development Bank, Merchant Bank, Basics of Mutual Funds, Credit Rating, An overview of micro finance.                                                                                                                                                                                                                                                        |
| UNIT – II    | <b>Financial Markets</b><br>Money Market in India: Importance, features and instruments, Measures to strengthen money market in India, Recommendations of the working group on money market.<br>Capital Markets in India: New issue market and stock exchange, Importance of stock exchanges, Role of The Securities and Exchange Board of India (SEBI), Meaning and Classification of Mutual Funds, Operation of the Funds, Net Asset Value, and Regulation of Mutual Funds in India.<br>Financial Instruments: Cash, Derivative, Foreign Exchange, Debt based and Equity based financial instruments. |
| UNIT – III   | <b>Principles and Practices of Insurance</b><br>Concept, Principles & Types of Insurance-Life Insurance, Micro Insurance, Annuities, Health Insurance, General Insurance, Motor Insurance, Marine Insurance, Property Insurance and Other Miscellaneous Insurance, The Concept of Risk and Classification of Risks, Insurance Documents, Online Insurance, Process of claim and settlement, Policy Terms and Conditions, Legal and Regulatory Aspects of Insurance (IRDA).                                                                                                                              |



## **UNIT - 1**

### **Meaning of Financial Services**

Financial Services refer to economic services provided by various financial institutions that deal with the management of money. It is an intangible product of financial markets like loans, insurance, stocks, credit card, etc. Financial services are products of institutions such as banking firms, insurance companies, investment funds, credit unions, brokerage firms, and consumer finance companies.

1. **Customer Oriented:** Financial services are customer-focused services that are offered as per the requirements of customers. Financial institutions properly study customer needs before designing and offering such services. They are meant to fulfill the specific needs of a customer which differs from person to person.
2. **Intangibility:** These services are intangible which makes their marketing a challenging task for financial institutions. Such institutions need to focus on building their brand image by providing innovative and quality products to customers. Firms enjoying better credibility in market are easily able to sell off their products.
3. **Inseparable:** Financial Services are produced and delivered at the same time simultaneously. These services are inseparable and can't be stored in advance. Here production and supply function both occurs at the same time.
4. **Manages Fund:** Financial services are specialized at managing funds of people. These services enable peoples in allocating their idle lying funds into useful means for earning revenues. Financial services provide various means to people for converting their savings into investment.
5. **Financial Intermediation:** These services does the work of financial intermediation as it brings together the lender and borrower. Financial services mobilize the funds of people who are having enough of it and made it available to the one who are in need of it.
6. **Market Based:** Financial services are market based which changes as per the changing conditions. It is a dynamic activity which varies as per the variations in socio-economic environment and varying needs of customers. importance and scope of Financial services in points
7. **Distributes Risk:** Risk distribution is the key feature offered by financial services. These services transfer the risk of an individual not willing to take among different persons who all are willing to bear it. Financial institutions diversify the risk and secure people against damages by providing them various insurance policies. importance and scope of Financial services in points

### **Importance and scope of financial services in points**

1 Essential for economic growth: Financial services play a crucial role in the development of the economy by facilitating investment, providing access to credit, and facilitating trade.

2 Diverse Range of services: Financial services encompass a wide range of services including banking, insurance, investment management, and capital markets.

3 Access to credit: Financial services provide access to credit for individuals, businesses, and governments, enabling them to invest in their future and drive economic growth.



4 Improved Standard Of Living: By providing access to credit and investment opportunities, financial services can improve the standard of living for individuals and communities.

5 Risk Management: Financial services help individuals and businesses manage financial risks through insurance and other risk management products.

6 Facilitation of trade: Financial services are essential for facilitating international trade by providing access to capital, currency exchange services, and trade financing.

7 Promotion of savings and investments: Financial services promote savings and investment by providing a range of savings and investment products.

8 Increased Financial Literacy: Financial services can also increase financial literacy and education, helping individuals make informed financial decisions.

9 Support for small businesses: Financial services play a crucial role in supporting small businesses by providing access to credit and investment capital.

10 Regulated Industry: Financial services are regulated by government agencies to ensure stability, transparency, and consumer protection in the financial system.

## Meaning of Indian Financial System

The Indian Financial System refers to a **structured network of financial institutions, markets, instruments, and services** that facilitate the flow of funds within the economy. It acts as a bridge between **savers** (individuals or institutions having surplus funds) and **borrowers** (businesses, industries, and government needing funds). Through this system, resources are mobilized and allocated for productive purposes, contributing to economic growth and development. Thus, a financial system can be said to play a significant role in the economic growth of a country by mobilizing the surplus funds and utilizing them effectively for productive purposes.

## Definition of Indian Financial System

### 1. According to Bhole (2004):

*"Financial system provides a mechanism by which savings are transformed into investments and credit creation for promoting economic development."*

### 2. General Definition:

*"The Indian Financial System is a framework that enables the transfer of funds from those who have surplus resources to those who need them, through a variety of financial institutions, instruments, and markets under a regulatory structure."*

## Example for Better Understanding

Let's take an example: Suppose you deposit your savings in a bank. The bank does not keep all the money idle; it lends it further to a company that needs funds for expansion. This way, your savings are mobilized for productive use, and in return, you also earn interest. This simple transaction shows how the financial system connects savers and borrowers efficiently.



✓ This definition highlights **four key components** of the financial system:

- **Financial Institutions** (Banks, NBFCs, Insurance companies)
- **Financial Markets** (Money Market, Capital Market, Forex Market)
- **Financial Instruments** (Shares, Bonds, Debentures, Derivatives)
- **Financial Services** (Banking, Insurance, Investment, Payment Systems)

### **Features of Financial System**

The financial system has certain distinct characteristics that make it essential for the economy. These include:

#### **1. Intermediary Role**

The most important feature is that it acts as a link between savers and borrowers. Households usually save money, while businesses and governments need funds. The financial system connects them efficiently.

#### **2. Wide Network of Institutions and Markets**

It is not a single entity but a network of banks, NBFCs, insurance companies, stock exchanges, and other intermediaries that function together to transfer funds.

#### **3. Regulated Framework**

Financial systems function under the supervision of regulators such as the Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), and Insurance Regulatory and Development Authority of India (IRDAI) to ensure fairness, transparency, and stability.

#### **4. Facilitates Capital Formation**

By converting savings into investments, the financial system helps in building capital stock (factories, infrastructure, machinery, etc.), which is necessary for economic growth.

#### **5. Provides Liquidity**

Financial markets ensure that assets can be converted into cash quickly, providing liquidity to investors. For example, shares can be sold on stock exchanges at any time.

#### **6. Risk Management**

It provides mechanisms to reduce and manage risks, such as insurance policies, derivatives (futures & options), and portfolio diversification.

#### **7. Dynamic and Evolving**

With technology (like UPI, digital banking, online trading), the financial system is continuously evolving to meet the changing needs of the economy.

### **Importance of Financial System**

The financial system is not just important for investors and borrowers but for the overall economy. Its significance can be explained as follows:



### **1. Mobilization of Savings**

The financial system encourages people to save by offering safe instruments like bank deposits, insurance, and mutual funds. These savings are then channelized into productive uses.

### **2. Capital Formation and Economic Growth**

By converting savings into investments, the financial system creates capital for industries and infrastructure, leading to economic development.

### **3. Efficient Allocation of Resources**

Funds flow to the most productive and profitable sectors. For example, venture capital flows to startups, while infrastructure bonds fund highways or power projects.

### **4. Promotes Financial Inclusion**

It provides access to financial services like credit, insurance, and payments to rural and weaker sections, thereby reducing inequality in society.

### **5. Facilitates Trade and Commerce**

The availability of credit, payment systems (like UPI, NEFT, RTGS), and banking facilities make domestic and international trade smoother and faster.

### **6. Stabilizes the Economy**

By regulating money supply, controlling inflation, and monitoring credit, the financial system helps in maintaining economic stability.

### **7. Provides Liquidity and Security**

Investors feel confident as they can easily convert their financial assets into cash whenever required, and regulatory frameworks ensure their protection.

## **FINANCIAL INSTITUTIONS**

A financial institution is an organization that deals with financial transactions such as deposits, loans, investments, and insurance. It acts as an intermediary between savers and borrowers, ensuring that funds flow from surplus units to deficit units. Examples include banks, insurance companies, mutual funds, and NBFCs.

### **Definition**

A financial institution may be defined as an establishment that mobilizes savings from the public and provides credit or financial services to individuals, businesses, and governments. According to Mishkin, *"A financial institution is a firm that provides financial services and acts as a channel between savers and borrowers."*



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**Features of Financial Institutions**

1. **Intermediary Role** – They act as a link between savers and borrowers by mobilizing idle funds and directing them to productive uses.
2. **Regulated Structure** – They work under the supervision of regulatory authorities like RBI, SEBI, IRDAI, ensuring stability and transparency.
3. **Dual Function** – They collect deposits, premiums, or investments from the public and use these funds to provide credit, loans, or financial services.
4. **Risk Management** – Institutions like insurance companies and mutual funds reduce risks through diversification and coverage.
5. **Liquidity Provider** – They ensure funds are available to borrowers while allowing savers to withdraw or liquidate when required.
6. **Specialization** – Many institutions are specialized, such as NABARD for agriculture, EXIM Bank for exports, and LIC for life insurance.

**Importance of Financial Institutions**

1. **Mobilization of Savings** – They encourage savings by providing safe investment avenues like bank deposits, insurance policies, and mutual funds.
2. **Capital Formation** – By channeling savings into investments, they promote industrial development and infrastructure growth.
3. **Credit Availability** – They provide loans and advances to individuals, businesses, and governments for productive purposes.
4. **Facilitates Trade and Payments** – Banks and financial firms ensure smooth payment systems (UPI, NEFT, RTGS) and support domestic and international trade.
5. **Risk Coverage** – Insurance companies and investment institutions protect individuals and businesses against financial uncertainties.
6. **Economic Development** – By financing agriculture, industries, and services, they contribute to balanced and sustainable economic growth.
7. **Support to Government** – They help governments raise funds through bonds and securities to finance public expenditure and welfare schemes.

Financial institutions are organizations that provide a variety of financial services and products to individuals, businesses, and governments. They play a crucial role in the functioning of the economy by channeling savings and investments into productive uses, facilitating transactions, and providing credit to help individuals and organizations grow.

**TYPES OF FINANCIAL INSTITUTIONS**

Financial institutions can be classified into two categories:

- A. Banking Institutions
- B. Non - Banking Financial Institutions

**Financial Market**

A financial market is a marketplace where financial instruments such as shares, bonds, debentures, and currencies are bought and sold. It provides a mechanism for investors and borrowers to interact directly. It ensures the smooth flow of funds from savers to users of capital.

**Definition**

A financial market may be defined as the place or system that facilitates the exchange of financial assets and helps in mobilizing funds. According to Gurley and Shaw, *“Financial markets are the markets where financial instruments are exchanged and financial resources are mobilized.”*



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**Features of Financial Market**

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1. **Flow of Funds** – It transfers money from surplus units (savers) to deficit units (borrowers) efficiently.
2. **Two-Way Interaction** – Provides a common platform for investors and borrowers to meet and transact.
3. **Variety of Instruments** – Includes shares, bonds, debentures, treasury bills, foreign exchange, and derivatives.
4. **Regulated Structure** – Functions under authorities like SEBI, RBI, ensuring transparency and fair trading.
5. **Liquidity Creation** – Enables investors to convert their securities into cash whenever required.
6. **Dynamic in Nature** – Keeps evolving with changes in technology, economy, and globalization.
7. **Classification** – Broadly divided into money market (short-term) and capital market (long-term).

**Importance of Financial Market**

1. **Mobilization of Savings** – Encourages individuals and institutions to invest their surplus funds into productive channels.
2. **Capital Formation** – Converts savings into investments, boosting industrial and economic development.
3. **Efficient Resource Allocation** – Directs funds to the most profitable and productive uses in the economy.
4. **Liquidity to Investors** – Provides investors with the facility to sell their securities and convert them into cash easily.
5. **Price Discovery** – Helps in determining the fair value of financial instruments through demand and supply.
6. **Promotes Trade and Industry** – Provides adequate finance for business expansion, modernization, and trade growth.
7. **Supports Government** – Assists governments in raising funds through the sale of bonds, treasury bills, and securities.

**Financial Instruments**

Financial instruments are monetary contracts or products that represent a legal agreement between two parties. They can be assets for one party (like shares for investors) and liabilities for another (like loans for borrowers). They are used for raising funds, investing, or managing risks.

**Definition**

A financial instrument is defined as any contract that gives rise to a financial asset for one entity and a financial liability or equity instrument for another entity. According to IFRS, *"A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity."*

**Features of Financial Instruments**

1. **Legal Contract** – Every financial instrument represents a legally binding agreement between two parties.
2. **Dual Nature** – It is an asset for the investor and a liability for the issuer or borrower.
3. **Tradability** – Many financial instruments (like shares, bonds) can be traded in financial markets.
4. **Variety** – Includes primary instruments (shares, debentures, bonds) and derivative instruments (futures, options).



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5. **Risk and Return** – Different instruments carry different levels of risk and provide corresponding returns.
6. **Liquidity** – Some instruments (like shares) are highly liquid, while others (like fixed deposits) are less liquid.
7. **Time Frame** – They may be short-term (treasury bills) or long-term (debentures, bonds).

**Importance of Financial Instruments**

1. **Mobilization of Funds** – Help in channelizing savings of individuals and institutions into productive investments.
2. **Facilitate Investments** – Provide investors with multiple avenues to invest according to their risk and return preferences.
3. **Support Capital Formation** – Convert household savings into capital for industries and infrastructure.
4. **Risk Management** – Derivative instruments like futures and options help investors hedge against risks.
5. **Liquidity Provision** – Many instruments can be easily converted into cash, giving flexibility to investors.
6. **Encourages Trade and Economy** – Provide financing to businesses and governments, thus boosting economic development.
7. **Price Discovery** – Instruments traded in markets help in determining fair prices through supply and demand.

**Reserve Bank of India**

The **Reserve Bank of India (RBI)** is the central bank of the country, established on **1st April 1935** under the RBI Act, 1934. Initially set up in Kolkata (later moved to Mumbai), it was privately owned but was **nationalized in 1949**. As the apex monetary authority, it regulates the issue of currency, controls credit and money supply, supervises commercial banks, manages foreign exchange under FEMA, and formulates monetary policy to ensure price stability and economic growth. It also promotes financial inclusion and acts as the lender of last resort.

The **Reserve Bank of India (RBI)** is the apex monetary authority of India and plays a central role in maintaining financial stability. It is headed by a Governor, assisted by Deputy Governors, and functions under the RBI Act, 1934. Its key responsibilities include issuing currency (except one-rupee notes and coins issued by the Government of India), controlling inflation through monetary policy tools like repo and reverse repo rates, regulating and supervising banks and NBFCs, managing the country's payment and settlement systems, and maintaining exchange rate stability. The RBI also fosters financial inclusion, protects consumer interests, and acts as the **lender of last resort** to ensure the stability of the banking system.

The Reserve Bank of India (RBI) is the central bank of India and acts as the regulator of the country's monetary policy. It was established in 1935 and is headquartered in Mumbai, India.

**Functions of the Reserve Bank of India (RBI)**

**1. Issue of Currency**

RBI has the sole authority to issue currency notes in India (except one-rupee notes and coins which are issued by the Government of India). It ensures the availability of clean and genuine currency to the public and maintains confidence in the monetary system.

**2. Monetary Policy Implementation**

RBI formulates and implements monetary policy with the aim of controlling inflation, ensuring



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price stability, and supporting economic growth. It uses tools like **repo rate, reverse repo rate, CRR, and SLR** to regulate the supply of money in the economy.

### **3. Regulation and Supervision of Banks**

RBI acts as the regulator of the banking system. It grants licenses to banks, monitors their functioning, ensures capital adequacy, prevents frauds, and maintains public confidence in the financial system.

### **4. Control of Credit and Inflation**

Through quantitative and qualitative credit control measures, RBI ensures that credit is available for productive purposes and inflation is kept under check. This helps in maintaining the stability of the economy.

### **5. Management of Foreign Exchange**

RBI manages foreign exchange under the **Foreign Exchange Management Act (FEMA), 1999**. It regulates transactions involving foreign currency, stabilizes the rupee's exchange rate, and facilitates smooth international trade.

### **6. Lender of Last Resort**

In case of financial crises, liquidity shortages, or bank failures, RBI provides emergency funding to banks and financial institutions. This prevents the collapse of the banking system and ensures stability in the economy.

### **7. Management of Government Debt and Securities**

RBI manages the borrowing programs of the central and state governments. It issues government securities, treasury bills, and bonds, and also helps in public debt management.

### **8. Regulation of Payment and Settlement Systems**

RBI oversees payment and settlement systems in India, ensuring fast and secure transactions. It promotes digital payments like **NEFT, RTGS, UPI, and IMPS** to strengthen the financial infrastructure.

### **9. Promotion of Financial Inclusion**

RBI takes initiatives to extend banking services to rural and weaker sections of society through schemes like **Priority Sector Lending (PSL), Jan Dhan Yojana**, and by encouraging digital and small finance banks.

### **10. Consumer Protection and Developmental Role**

RBI works to protect the interests of depositors and consumers, spreads financial literacy, and promotes innovations in banking and finance. It also plays a developmental role by supporting rural credit institutions and cooperative banks.

## **Commercial banks**

The term commercial bank refers to a financial institution that accepts deposits, offers checking account services, makes various loans, and offers basic financial products like certificates of deposit (CDs) and savings accounts to individuals and small businesses. A commercial bank is where most people do their banking.

Commercial banks make money by providing and earning interest from loans such as mortgages,



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auto loans, business loans, and personal loans. Customer deposits provide banks with the capital to make these loans.

Commercial banks are an important part of the economy. Not only do they provide consumers with an essential service, but they also help create capital and liquidity in the market. They ensure liquidity by taking the funds that their customers deposit in their accounts and lending them out to others. Commercial banks play a role in the creation of credit, which leads to an increase in production, employment, and consumer spending, thereby boosting the economy.

**Functions of Commercial Banks**

Commercial banks perform a wide range of functions, which can be grouped into **primary functions, secondary functions, and other functions.**

**1. Primary Functions**

**(a) Accepting Deposits**

This is the most basic function of commercial banks. They mobilize savings from the public in the form of deposits. Deposits are classified into:

- **Demand Deposits:** Withdrawable at any time.
  - *Savings Deposit:* Earns interest, encourages savings.
  - *Current Deposit:* Meant for business people; no interest but unlimited withdrawals.
- **Time Deposits:** Withdrawable only after a fixed period.
  - *Fixed Deposit:* Deposited for a fixed term, earns higher interest.
  - *Recurring Deposit:* Deposits made monthly for a specific period, suitable for salaried people.

**(b) Advancing Loans**

Banks use deposited funds to give loans and advances to individuals and businesses.

- **Loans:** A fixed amount sanctioned for a specific time, repayable with interest.
- **Advances:** Short-term financial assistance, repayable within a year (e.g., cash credit, overdraft, bills discounting).

**2. Secondary Functions**

**(a) Credit Creation**

Banks create credit by lending more than the actual deposits they have, through the process of deposit multiplication. This expands money supply in the economy.

**(b) Transfer of Funds**

Banks provide facilities like **NEFT, RTGS, IMPS, and Demand Drafts** to transfer funds from one place to another quickly and safely.

**3. Other Functions**

**(a) Agency Functions**

Banks act as agents of customers by providing services like collection of cheques, payment of bills, handling investments, and remittances.

**(b) Foreign Exchange Business**

Banks deal in foreign currency, enabling importers and exporters to buy and sell foreign exchange under RBI regulations.

**(c) General Utility Services**

Banks provide locker facilities, issue traveler's cheques, provide credit cards/debit cards, internet banking, and financial advisory services.

### **Role of Commercial Banks in Developing Economy**

- 1) Banks promote capital formation
- 2) Banks help in balanced regional development
- 3) Banks promote the right type of Industries
- 4) Banks create employment opportunities
- 5) Banks helps in trade and industry
- 6) Banks helps in developing nation to develop

### **Public sector Banks**

Public Sector Banks consist of the State Bank Group and Other Nationalised Banks. It was wholly and controlled by Government.

### **State Bank of India and its group**

The Reserve Bank of India, which is India's central bank, acquired a controlling interest in the Imperial Bank of India. On 1 July 1955, the Imperial Bank of India became the State Bank of India. In 2008, the Government of India acquired the Reserve Bank of India's stake in SBI so as to remove any conflict of interest because the RBI is the country's banking regulatory authority. In 1959, the government passed the State Bank of India (Subsidiary Banks) Act. This made eight banks that had belonged to princely states into subsidiaries of SBI. This was at the time of the First Five Year Plan, which prioritised the development of rural India. The government integrated these banks into the State Bank of India system to expand its rural outreach. In 1963 SBI merged State Bank of Jaipur (est. 1943) and State Bank of Bikaner (est.1944).

### **Nationalised Banks**

It refers to a bank in which govt. of India has **more than 50% stake**. It is also called the Public Sector Bank. So, there is no difference between public sector bank and nationalised bank.

### **Private Sector Banks**

Private Sector Banks are those banks, where private individuals or private companies own a major part of the bank's equity. Even though these banks follow the nation's central bank's guidelines, but they can formulate their independent financial strategy for the customers. A large part of these banks are traded on the stock market and anyone can buy a significant part of these bank's shares from the stock market.

Most private sector banks are very agile in their financial strategy. These privates can make a quick financial decision according to the market condition. For this reason, interest rates fluctuate quickly on both deposits and loans. They offer very reliable services to the customers. They also offer various customized services to the customer to fulfil their individual financial needs. There is no job security in private banks. Most employees work very hard to satisfy the customer's financial requirements. In these banks, the employees get promotions on their merit and performance.

However, private sector banks charge a little extra for their financial services. Compared to other banks, the interest rate on deposits is low in most private sector banks. Even though getting a loan in the private banks is very easy, but they charge more interest on these loans. Axis Bank is one of the best examples of private sector banks in India. This bank is very competitive and offers the best services to its customers.

### **The Regional Rural Banks (RRBs)**

**The Regional Rural Banks (RRBs)** were established in 1975 under the provisions of the Ordinance promulgated on 26th September, 1975 and Regional Rural Banks Act, 1976 with a view to developing the rural economy by providing, for the purpose of development of agriculture,



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trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs, and for matters connected therewith and incidental thereto.

### **Key Features of RRBs**

1. **Ownership Structure** – RRBs have a unique ownership pattern: **50% Government of India, 15% State Government, and 35% Sponsor Bank** (usually a public sector bank).
2. **Rural Orientation** – Their main objective is to provide credit and banking facilities to the rural and semi-urban population, focusing on agriculture and allied activities.
3. **Limited Area of Operation** – Each RRB operates within a **specific notified area**, usually a few districts of a state, which makes them region-focused.
4. **Concessional Lending** – They provide loans at **concessional rates of interest** to priority sector activities such as agriculture, small-scale industries, and rural artisans.
5. **Low Cost of Credit** – By mobilizing rural savings and recycling them into productive credit, they ensure availability of **low-cost credit** to weaker sections.
6. **Support from Sponsor Banks** – RRBs are sponsored by public sector banks which provide **managerial and financial support** in their functioning.
7. **Dual Regulation** – They are regulated by the **Reserve Bank of India (RBI)** and supervised by the **NABARD (National Bank for Agriculture and Rural Development)**

### **Co-operative banks**

Cooperative banks are a type of financial institution that is owned and controlled by its members, who are also customers of the bank. The primary aim of cooperative banks is to serve the financial needs of their members, rather than maximizing profits for external shareholders.

#### **Some key features of cooperative banks include:**

- 1 Member-owned: Cooperative banks are owned by their members, who are also customers of the bank. Members have a say in how the bank is run and share in its profits.
- 2 Focus on serving members: The main aim of cooperative banks is to serve the financial needs of their members, rather than maximizing profits.
- 3 Democratic control: Cooperative banks are run on a democratic basis, with members having an equal vote in major decisions, regardless of the size of their deposit.
- 4 Limited interest on loans: Cooperative banks often offer lower interest rates on loans to their members compared to commercial banks.
- 5 Community focus: Cooperative banks are often focused on serving the needs of specific communities, such as farmers, small business owners, or low-income households.

Cooperative banks can offer a range of financial products and services, including savings and checking accounts, loans, mortgages, and other types of financial services. They can play an important role in providing access to financial services to under banked communities.



### **Non-banking financial institution (NBFI)**

A non-banking financial institution (NBFI) or non-bank financial company (NBFC) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. NBFC facilitate bank-related financial services, such as investment, risk pooling, contractual savings, and market brokering.

Development bank, national or regional financial institution designed to provide medium- and long-term capital for productive investment, often accompanied by technical assistance, in poor countries.

The number of development banks has increased rapidly since the 1950s; they have been encouraged by the International Bank for Reconstruction and Development and its affiliates. The large regional development banks include the Inter-American Development Bank, established in 1959; the Asian Development Bank, which began operations in 1966; and the African Development Bank, established in 1964. They may make loans for specific national or regional projects to private or public bodies or may operate in conjunction with other financial institutions. One of the main activities of development banks has been the recognition and promotion of private investment opportunities. Although the efforts of the majority of development banks are directed toward the industrial sector, some are also concerned with agriculture.

### **Merchant Bank**

A merchant bank is a type of financial institution that provides various services to businesses, including underwriting, financing for trade, and issuing loans and securities. Merchant banks are typically more focused on providing financial services to companies and large corporations, rather than individual consumers.

Some key services offered by merchant banks include:

- 1 Corporate finance:** Merchant banks provide financial advice and assistance with mergers and acquisitions, initial public offerings (IPOs), and other types of corporate finance activities.
- 2 Trade financing:** Merchant banks assist businesses with financing trade activities, such as issuing letters of credit and providing short-term loans.
- 3 Investment banking:** Merchant banks often provide investment banking services, such as underwriting and selling securities.
- 4 Foreign exchange:** Merchant banks assist businesses with foreign exchange transactions and currency hedging.
- 5 Asset management:** Merchant banks can provide asset management services, such as managing portfolios of stocks, bonds, and other investments.

Merchant banks often have extensive networks and relationships with businesses, financial institutions, and governments around the world, which allows them to provide a range of specialized financial services to their clients.

### **Mutual Fund**

A mutual fund is a type of investment vehicle that pools money from many individual investors to purchase a diversified portfolio of stocks, bonds, or other securities. Mutual funds are managed by professional fund managers who invest the money in a variety of assets in accordance with the fund's investment objective.



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**Some key features of mutual funds include:**

- 1 **Diversification:** Mutual funds provide individual investors with access to a diversified portfolio of assets, which can help reduce the risk of investing in a single security.
- 2 **Professional Management:** Mutual funds are managed by professional fund managers who have expertise in selecting and managing investments.
- 3 **Liquidity:** Mutual funds are typically highly liquid, meaning that investors can buy and sell shares of the fund on any business day at the current net asset value (NAV) price.
- 4 **Low minimum Investment:** Mutual funds often have a low minimum investment requirement, making it possible for individual investors to get started with a relatively small amount of money.
- 5 **Cost-effectiveness:** Because mutual funds pool money from many investors, the costs of buying and selling securities, as well as the costs of professional management, are spread across the entire fund. This can make mutual funds a cost-effective option for individual investors.

However, it's important to remember that mutual funds, like all investments, carry risk, and the performance of a fund can be affected by a variety of factors, such as changes in the market, economic conditions, and the performance of individual securities within the fund. It's important to carefully research and understand a mutual fund before investing.

**Credit Rating**

A credit rating is an assessment of the creditworthiness of a borrower, such as a corporation, government, or financial institution. Credit ratings are issued by credit rating agencies, such as Moody's, Standard & Poor's (S&P), and Fitch Ratings, and provide investors with an independent evaluation of the borrower's ability to repay its debts.

Credit ratings are typically expressed as a letter grade, such as AAA, AA, A, BBB, etc. The highest credit rating, AAA, indicates the lowest default risk, while the lowest rating, D, indicates that the borrower has already defaulted on its debts.

**Some key aspects of credit ratings include**

- 1 **Financial health:** Credit ratings take into account a borrower's financial health, including its revenue, earnings, debt levels, and cash flow.
- 2 **Ability to repay debts:** Credit ratings also assess a borrower's ability to repay its debts, taking into account its ability to generate cash flow, its debt structure, and other factors.
- 3 **Market conditions:** Credit ratings take into account the overall economic and market conditions, as well as industry-specific risks, to provide a more complete assessment of a borrower's creditworthiness.
- 4 **Default risk:** Credit ratings provide an assessment of the default risk of a borrower, which is the risk that it will not be able to repay its debts on time.
- 5 **Impact on borrowing costs:** Credit ratings can have a significant impact on the borrowing costs of a borrower. Higher credit ratings can result in lower borrowing costs, while lower credit ratings can result in higher borrowing costs.



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Credit ratings are widely used by investors, including bondholders and banks, as a tool for making informed investment decisions. They provide a relatively objective and independent assessment of a borrower's creditworthiness and can help investors to understand the level of risk associated with a particular investment.

**An overview of Micro Finance**

Micro finance is a financial service that provides small loans, savings accounts, insurance, and other financial services to low-income individuals, who may not have access to traditional banking services. The goal of microfinance is to provide access to financial services to people who would otherwise be excluded from the formal financial system and to help them improve their standard of living and reduce poverty.

**Some key features of microfinance include:**

- 1 Small Loans: Microfinance institutions provide small loans to low-income individuals, typically ranging from a few hundred dollars to a few thousand dollars. These loans are used to start or expand a small business, purchase household goods, or pay for emergencies.
- 2 Savings accounts: Microfinance institutions also offer savings accounts, allowing low-income individuals to save money and earn interest on their deposits.
- 3 Insurance: Some microfinance institutions offer insurance products, such as life and health insurance, to their clients.
- 4 Community-based lending: Microfinance institutions often use a group-based lending model, where a group of individuals guarantee each other's loans and support each other's businesses.
- 5 Empowerment: Microfinance is seen as a tool for empowering women and marginalized communities by providing them with access to financial services and helping them to improve their standard of living.

Microfinance has been successful in providing financial services to millions of low-income individuals around the world and has been credited with helping to reduce poverty, increase economic growth, and improve the standard of living for many people. However, it is important to note that microfinance is not a panacea for poverty and that success depends on many factors, including the quality of the institutions providing the services, the regulatory environment, and the cultural and economic context.



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## **UNIT – II**

### **FINANCIAL MARKETS**

#### **MONEY MARKET IN INDIA**

The **money market** is a part of the financial system where short-term funds are borrowed and lent. It deals in highly liquid financial instruments with a maturity period of **less than one year**. It provides a platform for governments, banks, financial institutions, and corporations to manage their short-term liquidity needs. In simple words, it is a market for **short-term loans and investments** that helps maintain liquidity and stability in the economy.

The money market is a market for financial assets that are close substitutes for money. It is a market for overnight to short-term funds and instruments having a maturity period of one or less than one year. It is not a place (like the Stock Market), but an activity conducted by telephone. The money market constitutes a very important segment of the Indian financial system.

According to the **Reserve Bank of India (RBI)**: *"The money market is the center for dealings, mainly of a short-term character, in monetary assets; it meets the short-term requirements of borrowers and provides liquidity to lenders."*

The characteristics of the money market are:

- ❑ **Short-term Nature** – Deals only in short-term instruments (maturity less than one year).
- ❑ **Highly Liquid Instruments** – Instruments like Treasury Bills, Commercial Papers, and Call Money are easily tradable and liquid.
- ❑ **No Physical Exchange** – It is not an organized physical market but a network of institutions, banks, and participants.
- ❑ **Role of RBI** – The Reserve Bank of India plays a central role in regulating and controlling the money market.
- ❑ **Participants** – Includes banks, financial institutions, mutual funds, corporate bodies, and government.
- ❑ **Safety of Investment** – Since instruments are short-term and often government-backed, they involve low risk.

#### **Functions of the Money Market**

A money market is generally expected to perform three broad functions:

- (i) Provide a balancing mechanism even out the demand for and supply of short-term funds.
- (ii) Provide a focal point for central bank intervention for influencing liquidity and general level of interest rates in the economy.
- (iii) Provide reasonable access to suppliers and users of short-term funds to fulfill their borrowings and investment requirements at an efficient market clearing price.

Besides the above functions, a well-functioning money market facilitates the development of a market for longer term securities. The interest rates for extremely short-term use of money serve as a benchmark for longer-term financial instruments.



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**Benefits of an Efficient Money Market**

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**1. Provides Liquidity**

The money market provides a ready avenue for lenders to invest surplus funds for short periods and for borrowers to meet short-term financial needs. This ensures continuous liquidity in the financial system.

**2. Supports Monetary Policy**

The Reserve Bank of India uses money market instruments to regulate credit, control inflation, and maintain price stability. Thus, it acts as an effective tool for the implementation of monetary policy.

**3. Encourages Savings and Investment**

By offering short-term instruments such as Treasury Bills, Commercial Papers, and Certificates of Deposit, the money market encourages individuals and institutions to save and invest idle funds.

**4. Provides Working Capital to Businesses**

Businesses can raise short-term funds through money market instruments to finance their day-to-day operations, thus ensuring smooth functioning without cash flow problems.

**5. Promotes Financial Stability**

By balancing the demand and supply of short-term funds, the money market prevents financial imbalances, ensuring stability in the overall economy.

**6. Efficient Utilization of Surplus Funds**

The money market channels surplus funds from lenders (like households and institutions) to borrowers (like businesses and government), leading to productive use of idle resources.

**7. Integration of Financial Markets**

The money market acts as a link between the central bank, commercial banks, financial institutions, and capital markets, ensuring coordination in the financial system.

**The Indian Money Market**

The **Indian Money Market** refers to the market for short-term funds (up to one year) in India. It consists of the **organized sector** (RBI, commercial banks, cooperative banks, financial institutions) and the **unorganized sector** (moneylenders, chit funds, indigenous bankers). Its main purpose is to provide liquidity to borrowers and short-term investment opportunities to lenders.

The average turnover of the money market in India is over Rs 40,000 crore daily. This is more than 3 per cent of the total money supply in the Indian economy and 6 per cent of the total funds that commercial banks have let out to the system. This implies that 2 per cent of the annual GDP of India gets traded in the money market in just one day. Even though the money market is many times larger than the capital market, it is not even a fraction of the daily trading in developed markets.



### **Features of Indian Money Market**

1. **Dual Structure** – It consists of both an organized sector regulated by the RBI and an unorganized sector dominated by indigenous moneylenders.
2. **Short-term Focus** – Deals only in short-term credit instruments such as call money, Treasury Bills, Commercial Papers, and Certificates of Deposit.
3. **Role of RBI** – The RBI is the apex authority that regulates and supervises the money market to maintain liquidity and credit control.
4. **Presence of New Instruments** – Post-reforms, several modern instruments like Commercial Papers, Treasury Bills, and Mutual Funds have been introduced.
5. **High Liquidity** – Money market instruments are highly liquid and easily convertible into cash.
6. **Seasonality** – Seasonal demand, especially during agricultural harvest and sowing periods, creates fluctuations in money market activities.
7. **Integration with Global Market** – Liberalization and globalization have connected the Indian money market with international capital flows.

### **Defects of Indian Money Market**

Despite reforms, the Indian money market still suffers from several shortcomings:

1. **Lack of Integration** – The organized sector and unorganized sector are not well integrated, leading to inefficiency and uneven credit flow.
2. **Unorganized Sector Dominance** – Indigenous bankers and moneylenders still play a big role, especially in rural areas, outside RBI's control.
3. **Limited Instruments** – Although reforms have introduced new instruments, the market is still not as diversified or developed as advanced countries.
4. **Seasonal Shortage of Funds** – Credit demand rises sharply during agricultural seasons, causing instability and high interest rates.
5. **High Dependence on Cash Credit** – Indian banks rely heavily on the cash credit system instead of developing a genuine bill market.
6. **Inadequate Banking Facilities** – Large sections of rural and semi-urban areas still lack access to organized banking facilities.
7. **Interest Rate Disparities** – Different segments of the market have different interest rates due to lack of integration, creating inefficiency.
8. **Underdeveloped Secondary Market** – Secondary markets for money market instruments (like commercial bills) are still weak

### **Solutions / Measures for Improvement**

Several reforms have been suggested and implemented to strengthen the Indian money market:

1. **Integration of Markets** – Efforts should be made to bring the unorganized sector under regulation and integrate it with the organized sector.
2. **Strengthening Bill Market** – Promote genuine commercial bill financing instead of cash credit to improve trade-related finance.
3. **Expansion of Banking Facilities** – More rural and semi-urban branches, financial literacy, and digital banking should be promoted for wider coverage.
4. **Interest Rate Rationalization** – Narrow down interest rate disparities by deregulating rates and promoting market-based pricing.
5. **Promote New Instruments** – Encourage the use of Commercial Papers, Certificates of Deposit, Treasury Bills, and Repo instruments to deepen the market.
6. **Liquidity Management by RBI** – The RBI should continue using monetary policy tools like repo rate, reverse repo, and CRR to stabilize liquidity.



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7. **Strengthening DFHI and Financial Institutions** – Enhance the role of institutions like DFHI (Discount and Finance House of India) to promote secondary trading and liquidity in money market instruments.
8. **Encouraging Foreign Participation** – More foreign institutional investors (FIIs) and NRIs can be allowed in select instruments to improve depth.

### **Role of the Reserve Bank of India in the Money Market**

The Reserve Bank of India is the most important constituent of the money market. The market comes within the direct purview of the Reserve Bank regulations

The aims of the Reserve Bank's operations in the money market are:

- (i) to ensure that liquidity and short-term interest rates are maintained at levels consistent with the monetary policy objectives of maintaining price stability;
- (ii) to ensure an adequate flow of credit to the productive sectors of the economy; and
- (iii) to bring about order in the foreign exchange market.

The Reserve Bank influences liquidity and interest rates through a number of operating instruments cash reserve requirement (CRR) of banks, conduct of open market operations (OMOS), repos, change in bank rates and, at times, foreign exchange swap operations.

### **Steps to Develop the Money Market in India**

The Indian money market was traditionally underdeveloped, fragmented, and dominated by informal players. To modernize and integrate it with the global system, several reforms were introduced during the **1980s and 1990s** by the Reserve Bank of India (RBI) and the Government of India. These steps aimed to diversify money market instruments, improve liquidity, and shift towards a market-based system.

#### **1. Reforms in the 1980s**

In 1985, the **Chakravarty Committee** reviewed the monetary system and highlighted the need to develop money market instruments. Following this, the **Vaghul Committee (1987)** laid the blueprint for an organized money market. Based on its recommendations, the **Discount and Finance House of India (DFHI)** was set up in 1988 to provide liquidity and promote a secondary market for short-term instruments.

#### **2. Introduction of New Instruments**

Between 1988–1990, several instruments such as **182-day Treasury Bills, Certificates of Deposit (CDs), Inter-Bank Participation Certificates, and Commercial Paper (1990)** were introduced. These innovations gave corporates and banks new avenues for raising short-term funds and improved depth in the market.

#### **3. Deregulation of Interest Rates**

Earlier, interest rates in the money market were controlled by the RBI. Starting in 1988, the **interest rate ceiling on call money** was removed in stages, beginning with DFHI operations. By 1989, interest rate ceilings on inter-bank term money, rediscounting of bills, and inter-bank participations were also withdrawn. This marked a gradual shift from **administered interest rates to market-determined rates**.



#### **4. Reforms in the 1990s**

The **Narasimham Committee (1991)** examined the financial sector and suggested wide-ranging reforms. Based on its recommendations, the **Securities Trading Corporation of India (STCI)** was established in 1994 to develop a secondary market in government securities and public sector bonds.

#### **5. Entry of New Participants**

During the 1990s, barriers to entry in the money market were reduced. The **Primary Dealer system (1995)** and **Satellite Dealer system (1999)** were introduced to inject liquidity. Foreign Institutional Investors (FIIs), mutual funds, and non-bank financial institutions were allowed to participate. This widened the investor base and increased market efficiency.

#### **6. Financial Innovations**

Several new methods and instruments were introduced such as **auctioned Treasury Bills, repos, and varying maturities of short-term debt instruments**. A shift from the **cash-credit system to a loan-based system** improved cash management discipline for borrowers and created a true short-term funds market.

#### **7. Reforms in Government Borrowing**

Ad hoc Treasury Bills were discontinued and replaced by **Ways and Means Advances (WMA)** linked to the bank rate. This reduced automatic monetization of government deficits and brought more transparency to fiscal management.

#### **8. New Monetary Control Instruments**

The RBI reactivated the **Bank Rate (1997)** and introduced a mix of auctions, private placements, and open market operations for liquidity control. The **Liquidity Adjustment Facility (LAF)** was launched in June 2000 (after an interim trial in 1999) to regulate short-term interest rates by managing day-to-day liquidity through repos and reverse repos.

#### **9. Other Measures**

The **minimum lock-in period for money market instruments** was reduced to 15 days, making them more flexible. Interbank liabilities were exempted from **CRR and SLR**, encouraging the growth of the term money market. Together, these measures enhanced liquidity, efficiency, and integration of the money market.

#### **Money Market Centers**

There are money market centers in India at Mumbai, Delhi, and Kolkata. Mumbai is the only active money market centers in India with money flowing in from all parts of the country getting transacted there.



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**Money Market Instruments**

The instruments traded in the Indian money market are

- (i) Treasury bills (T-bills)
- (ii) Call/notice money market–Call (overnight) and short notice (up to 14 days)
- (iii) Commercial paper (CP)
- (iv) Certificates of deposit (CD)
- (v) Commercial bills (CB)

Call/notice money market and treasury bills form the most important segments of the Indian money market. Treasury bills, call money market, and certificates of deposit provide liquidity for government and banks while commercial paper and commercial bills provide liquidity for the commercial sector and intermediaries

**4.2 TREASURY BILLS**

Treasury Bills, commonly known as **T-Bills**, are short-term financial instruments issued by the **Government of India** to meet its short-term borrowing requirements. They are issued at a discount and redeemed at face value, and are considered one of the safest money market instruments because they are backed by the government. Treasury bills are available for a minimum amount of Rs 25,000 and in multiples thereof.

Treasury Bills are short-term instruments issued by the Reserve Bank on behalf of the government to tide over short-term liquidity shortfalls. This instrument is used by the government to raise short-term funds to bridge seasonal or temporary gaps between its receipts (revenue and capital) and expenditure. T-bills are repaid at par on maturity. The difference between the amount paid by the tenderer at the time of purchase (which is less than the face value) and the amount received on maturity represents the interest amount on T-bills and is known as the discount. Tax deducted at source (TDS) is not applicable on T-bills.

According to the **Reserve Bank of India (RBI)**:

*“Treasury Bills are short-term debt instruments issued by the Government of India for maturities of less than one year, which are sold at a discount and redeemed at par.”*

In simple words, Treasury Bills are **zero-coupon securities** that do not pay interest but give returns in the form of the difference between the purchase price (discounted) and redemption value (face value).

**Features of T-bills**

- **Short-Term Instruments** – T-Bills are issued for **less than one year** (91 days, 182 days, and 364 days maturities).
- **Issued at Discount** – They are sold at a price lower than their face value and redeemed at par, the difference being the investor’s return.
- **Zero-Coupon Securities** – T-Bills do not carry an explicit interest rate; returns come only from the discount. In other words, they have an assured yield, low transaction cost, and are eligible for inclusion in the securities for SLR purposes.
- **Government Backed** – They are issued by the Government of India, making them virtually **risk-free** and highly secure.
- **Highly Liquid** – T-Bills are easily tradable in the money market, ensuring quick conversion into cash when needed.
- **Auction Based** – Most T-Bills are issued through **auctions conducted by the RBI**, ensuring transparency and market-determined rates. At present, there are 91-day and 364-day T-bills in vogue. The 91-day T-bills are auctioned by RBI every Friday and the 364-day T-bills every alternate Wednesday that is, the Wednesday preceding the reporting Friday.

**Types of Treasury Bills in India**

**1. Ad-hoc Treasury Bills (Discontinued)**



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- Introduced in **1955** and issued only to the **RBI, State Governments, and approved institutions** (like semi-government bodies).
- They were not marketable and could not be traded.
- Used mainly to provide temporary accommodation to the government when expenditure exceeded revenue.
- This system was discontinued in **1997**, after an agreement between the Government of India and RBI.

## **2. Auctioned Treasury Bills**

- Introduced in **1986** as part of financial reforms.
- These are sold through **auctions conducted by RBI**, where investors (banks, institutions, individuals) can bid.
- Issued in maturities like **91 days, 182 days, and 364 days**.
- Rates are determined by competitive bidding (market-based), making them attractive to investors.
- These are the most common form of T-Bills in India today.

## **3. On Tap Treasury Bills**

- These are Treasury Bills available for **continuous subscription** from the RBI at fixed rates.
- Issued mainly to State Governments, semi-government bodies, and approved financial institutions.
- Investors can “tap” them at any time, hence the name.
- Less significant compared to auctioned T-Bills and not as widely used.

## **Importance of T-Bills**

The development of T-bills is at the heart of the growth of the money market. T-bills play a vital role in the cash management of the government. Being risk free, their yields at varied maturities serve as short-term benchmarks and help in pricing different floating rate products in the market. The T-bills market is the preferred central bank tool for market intervention to influence liquidity and short-term interest rates. The development of the T-bills market is a pre- condition for effective open market operations.

## **CALL/NOTICE MONEY MARKET**

The **Call Money Market** is an important part of the Indian money market where **short-term funds** are borrowed and lent, usually for **1 day to 14 days**. When the loan is for just **one day**, it is called **Call Money** (payable on call or demand). If the maturity extends up to **14 days**, it is called **Notice Money**. This market is primarily used by **banks and financial institutions** to maintain their daily liquidity and meet the statutory reserve requirements (like Cash Reserve Ratio – CRR and Statutory Liquidity Ratio – SLR).

It is by far the most visible market as the day-to-day surplus funds, mostly of banks, are traded there. The call money market accounts for the major part of the total turnover of the money market. It is a key segment of the Indian money market. Since its inception in 1955-56, the call money market has registered a tremendous growth in volume of activity.



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The call money market is a market for very short-term funds repayable on demand and with a maturity period varying between one day to a fortnight. When money is borrowed or lent for a day, it is known as call (overnight) money. Intervening holidays and/or Sundays are excluded for this purpose. When money is borrowed or lent for more than a day and upto 14 days, it is known as notice money. No collateral security is required to cover these transactions. The call money market is a highly liquid market, with the liquidity being exceeded only by cash. It is highly risky and extremely volatile as well.

### Features of Call Money

1. **Very Short-Term** – Call money is borrowed and lent for **1 day** (overnight). If it extends up to 14 days, it becomes **Notice Money**.
2. **Unsecured Loan** – It is a **clean loan** without any collateral, hence restricted to highly reliable participants like banks.
3. **Market Participants** – Mainly **scheduled commercial banks (except RRBs and cooperative banks), primary dealers**, and some financial institutions.
4. **Used for Liquidity Management** – Banks borrow call money to meet **short-term fund mismatches** or to maintain **CRR/SLR** with RBI.
5. **Highly Volatile Rates** – The **Call Money Rate** (interest rate) changes daily depending on demand and supply of funds in the market.
6. **Regulated by RBI** – RBI regulates the call money market as part of its monetary policy to maintain liquidity and stability in the financial system.
7. **No Collateral Requirement** – Transactions are based on the mutual trust and creditworthiness of participating banks and institutions.

### Why Call Money is Required

Call Money is mainly needed by **commercial banks** to meet their **Cash Reserve Ratio (CRR)** requirements with the RBI. Since CRR is a fixed percentage of banks' **Net Demand and Time Liabilities (NDTL)** that must be kept in cash with the RBI, banks borrow in the **call money market** whenever they face short-term shortages.

The RBI uses CRR as a tool of **monetary control** to regulate inflation, liquidity, and growth. For example, CRR was as high as **15% in 1991** but reduced to **4.75% in 2002** to inject liquidity. Earlier, banks had to maintain **85% of CRR daily**, but reforms in 1999–2000 (lagged reserve system, lower daily minimums) gave flexibility and prevented sudden spikes in call rates. Today, the **Call Money Market** works as an **OTC interbank market** (over 80% transactions are interbank), helping banks adjust liquidity, especially on **reporting Fridays** when CRR must be fully met.

### Commercial Paper

Commercial Paper is a short-term, unsecured money market instrument issued by large companies to raise funds for their immediate financial needs, such as working capital requirements. It is issued in the form of a **promissory note** at a discount to face value and redeemed at par on maturity. Only companies with strong credit ratings are allowed to issue CPs, as they are not backed by collateral.

According to the **RBI**, “Commercial Paper is an unsecured money market instrument issued in the form of a promissory note, with a fixed maturity, transferable by endorsement and delivery.”

In simple words, CP is a **short-term debt instrument** issued by financially sound companies to meet short-term funding needs.



### **Features of Commercial Paper**

1. **Short-Term Instrument** – CPs have a maturity period ranging from **7 days to 1 year** (365 days).
2. **Unsecured in Nature** – They are not backed by collateral; only companies with high creditworthiness can issue them.
3. **Issued at Discount** – CPs are issued at a price lower than their face value and redeemed at par, the difference being the investor's return.
4. **Eligibility** – Generally issued by **large corporates, primary dealers, and financial institutions** with a good credit rating (approved by SEBI and RBI).
5. **Mode of Issuance** – Issued in denominations of **₹5 lakh or multiples**, making them suitable for institutional investors like banks, mutual funds, and insurance companies.
6. **Tradability** – CPs are freely transferable and can be traded in the secondary market, providing liquidity to investors.
7. **Regulated by RBI** – The Reserve Bank of India lays down guidelines regarding eligibility, credit rating, maturity period, and issuance procedures.

### **Certificate of Deposit**

A **Certificate of Deposit (CD)** is a short-term, negotiable money market instrument issued by commercial banks and financial institutions to raise large sums of money from individuals, companies, and institutional investors. It is issued in dematerialized form or as a promissory note for a fixed maturity and carries an interest rate. CDs are used as an alternative to bank deposits but are tradable in the secondary market, providing liquidity to investors.

According to the **RBI**, *"A Certificate of Deposit is a negotiable money market instrument issued in dematerialized form or as a promissory note, issued by scheduled commercial banks and select financial institutions, against funds deposited at the bank for a specified period."*

In simple words, a CD is a **receipt issued by a bank for funds deposited with it for a fixed period at a fixed rate of interest**, which can be traded in the money market.

### **Features of Certificate of Deposit**

1. **Issuer** – CDs are issued by **scheduled commercial banks** (except RRBs and cooperative banks) and select **financial institutions** approved by RBI.
2. **Maturity Period** – For banks: **7 days to 1 year**; for financial institutions: **1 year to 3 years**.
3. **Minimum Amount** – Issued in denominations of **₹5 lakh and multiples thereof**, making them suitable for institutional investors.
4. **Transferability** – CDs are **negotiable instruments** and can be traded in the secondary market before maturity, ensuring liquidity.
5. **Form of Issue** – Available in **dematerialized form (electronic)** or as a **promissory note**.
6. **No Premature Withdrawal** – Unlike bank deposits, CDs **cannot be withdrawn before maturity**, but they can be sold in the secondary market.
7. **Interest** – Can be issued at **discounted value** (like T-Bills) or on a **fixed interest basis**.
8. **Regulated by RBI** – RBI specifies eligibility, issue terms, denominations, and maturity guidelines.

### **Commercial bills**

A **Commercial Bill**, also known as a **Trade Bill**, is a short-term, negotiable financial instrument used in trade transactions. It represents a claim for payment arising from the **sale of goods or services** and is typically drawn by a seller on the buyer, to be paid on a specified future date. Commercial bills help businesses **raise short-term finance** by discounting the bill with banks before maturity.



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According to **R.P. Kent**:

*"A bill of exchange arising out of trade is called a commercial bill. It is drawn by a seller on the buyer to be paid at a future date."*

In simple words, a commercial bill is a **short-term credit instrument** used in trade where the seller can get immediate funds by discounting it with a bank.

### **Features of Commercial Bills**

1. **Short-Term Instrument** – Usually has a maturity of **up to 90–180 days**.
2. **Arises Out of Trade** – Created as a result of **sale and purchase of goods**, not for personal or financial transactions.
3. **Negotiable Instrument** – Can be **endorsed or transferred** to another party or discounted with a bank before maturity.
4. **Parties Involved** – Involves **drawer (seller), drawee (buyer), and payee (holder or bank)**.
5. **Discounting Facility** – Can be **discounted by commercial banks** to get immediate funds instead of waiting for the due date.
6. **Secure Credit Instrument** – Since it is backed by goods sold, it is considered **safer than unsecured instruments**.
7. **Used for Working Capital** – Mainly helps businesses **finance day-to-day operations** and manage short-term liquidity.

### **Money Market Intermediaries**

The **Money Market** is a market for short-term funds (maturity less than one year), where various institutions borrow and lend money to maintain liquidity and meet short-term financial requirements. While participants include both borrowers and lenders, the smooth functioning of the market largely depends on certain **intermediaries** who facilitate transactions, provide liquidity, and ensure stability.

#### **1. Reserve Bank of India (RBI)**

- The **apex monetary authority** and the most important intermediary in the Indian money market.
- Regulates and supervises all money market activities.
- Issues short-term government securities such as **Treasury Bills**.
- Uses monetary policy instruments (**repo, reverse repo, CRR, SLR, OMOs**) to influence liquidity and interest rates.
- Acts as the **lender of last resort**.

#### **2. Commercial Banks**

- The most **active intermediaries** in the money market.
- Borrow and lend funds in the **call money market** to manage day-to-day liquidity.
- Invest in **T-Bills, Commercial Papers (CPs), and Certificates of Deposit (CDs)**.
- Act as both **lenders** (when surplus funds are available) and **borrowers** (when liquidity is tight).
- Facilitate **credit creation** and smooth circulation of funds in the economy.

#### **3. Cooperative Banks**

- Operate mainly in rural and semi-urban areas.
- Participate as intermediaries by borrowing or lending in the money market, though at a smaller scale.
- Help channelize funds in the **agricultural and cooperative sector**.



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#### **4. Non-Banking Financial Institutions (NBFI)**

- Includes institutions like **LIC, UTI, GIC, Mutual Funds, Development Financial Institutions**.
- Act as important investors in money market instruments like **T-Bills, CPs, CDs**.
- Though they cannot directly participate in the **call money market**, they lend indirectly through approved dealers.
- Provide stability and depth by channelizing **household and institutional savings** into short-term investments.

#### **5. Discount and Finance House of India (DFHI)**

- Established in **1988** by the RBI, public sector banks, and financial institutions to strengthen the money market.
- Provides liquidity by **discounting and rediscounting** short-term instruments like **T-Bills, CPs, and CDs**.
- Develops a **secondary market** in money market instruments, making them tradable and more liquid.
- Acts as a **market maker** and ensures smooth functioning of the money market.

#### **6. Primary Dealers (PDs)**

- Specialized institutions authorized by RBI to deal in **government securities and Treasury Bills**.
- Act as intermediaries between the government (issuer) and investors.
- Underwrite government securities and participate in auctions of T-Bills.
- Help create liquidity in the secondary market for government securities.

#### **7. Corporate Houses (via CPs)**

- Though not traditional intermediaries, large corporates issue **Commercial Papers** as a substitute for bank loans.
- They indirectly act as intermediaries by mobilizing funds from surplus holders and using them for business needs.

#### **Recommendations of the Working Group on Money Market**

The **Working Group on Money Market**, under the chairmanship of **Shri N. Vaghul (1987)**, was constituted by the **Reserve Bank of India (RBI)** to review the functioning of the Indian money market and suggest measures to make it more efficient and developed. At that time, the Indian money market was underdeveloped, segmented, dominated by the unorganized sector, and lacked adequate financial instruments for short-term borrowing and lending. The committee's recommendations provided the basis for significant reforms in India's money market during the late 1980s and 1990s.

#### **Recommendations of the Vaghul Committee**

##### **. Introduction of New Instruments**

The committee emphasized that the Indian money market needed a wider range of short-term instruments to meet the needs of different participants. It recommended:

- **Commercial Paper (CP):** To enable highly rated corporate borrowers to directly raise short-term funds from the market instead of relying solely on banks.
- **Certificates of Deposit (CD):** To allow banks to raise short-term funds from investors, especially during liquidity shortages.
- **Inter-Bank Participation Certificates (IBPCs):** To provide flexibility in asset-liability management of banks and enable inter-bank fund adjustments.



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## **2. Development of Call/Notice Money Market**

The call money market, which deals with overnight and very short-term funds, was narrow and dominated by a few banks. The group recommended:

- Broadening participation by including financial institutions and mutual funds.
- Reducing reliance on RBI for day-to-day liquidity support.
- Allowing market-determined rates to improve efficiency.

This was expected to make the call money market a central pillar of short-term liquidity management.

## **3. Reform of Treasury Bills Market**

The existing Treasury Bills were unattractive because of low fixed interest rates. The committee suggested:

- **Auction system for Treasury Bills** instead of fixed coupon rates, so that yields are market-related.
- Introduction of **shorter maturity Treasury Bills** (e.g., 91-day, 182-day, and 364-day bills) to provide more flexibility.

This helped to make government securities a more attractive investment and improved the borrowing process of the government.

## **4. Bill Market Development**

The Indian system of financing trade was heavily dependent on **cash credit**, which created inefficiencies. The committee recommended:

- Encouraging banks to finance trade through **commercial bills** rather than cash credit.
- Developing a **genuine bill market** by standardizing bills, rediscounting facilities, and secondary market support.

This was aimed at promoting financial discipline and linking credit more closely with actual trade.

## **5. Establishment of DFHI (Discount and Finance House of India)**

The group strongly felt that a specialized institution was needed to promote secondary market trading in money market instruments. It recommended the creation of **DFHI**, which was set up in 1988 jointly by the RBI, public sector banks, and financial institutions. DFHI was expected to:

- Provide liquidity to Treasury Bills, commercial bills, and other money market instruments.
- Act as a market-maker by discounting and rediscounting instruments.
- Strengthen the integration of different segments of the money market.

## **6. Broadening Market Participation**

The committee recognized that the money market was too narrowly dominated by banks. It recommended:

- Allowing **mutual funds, insurance companies, and other financial institutions** to participate actively.
- Encouraging corporates to directly access the market through CPs.

This diversification was aimed at increasing depth, competition, and liquidity.

## **7. Interest Rate Deregulation**

The money market suffered from controlled interest rates which limited efficiency. The group recommended that interest rates on money market instruments should be **market-determined**, allowing supply and demand forces to operate freely.

## **8. Integration and Regulation**

The group recommended closer integration of the organized and unorganized money market segments. It also stressed:

- Better coordination between **RBI, commercial banks, and other institutions**.
- A gradual phasing out of reliance on the unorganized sector by strengthening the organized sector.



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## **CAPITAL MARKET**

### **6 INTRODUCTION**

The **capital market** is a part of the financial system that deals with raising and investing long-term funds. Unlike the money market, which deals in short-term credit, the capital market is concerned with **medium- and long-term financing** for industry, trade, and government. It mobilizes savings from individuals and institutions and channels them into productive investments like shares, debentures, bonds, and other long-term securities. In simple words, the capital market is the market for **long-term funds** where investors invest their savings and businesses/governments raise funds for development and expansion.

The **Capital Market** is a segment of the financial system where **long-term funds** are raised and invested. It deals with securities that have a **maturity period of more than one year**, such as **shares, debentures, bonds, and government securities**.

The primary purpose of the capital market is to channel **savings from individuals, institutions, and organizations** into **productive investments** for industrial, infrastructural, and economic development. Unlike the money market, which deals in short-term funds, the capital market focuses on **long-term financing**. In simple terms, it is a market where companies, financial institutions, and governments raise long-term funds, and investors invest their savings to earn returns. The capital market aids economic growth by mobilising the savings of the economic sectors and directing the same towards channels of productive uses. This is facilitated through the following measures.

- 1.. Issue of primary securities in the primary market', that is, directing cash flow from the surplus sector to the deficit sectors such as the government and the corporate sector.
- (ii) Issue of "secondary securities in the primary market, that is, directing cash flow from the surplus section to financial intermediaries such as banking and non-banking financial institutions.
- 1.. Secondary market' transactions in outstanding securities which facilitate liquidity. The liquidity of the stock market is an important factor affecting growth. Many profitable projects require long-term finance and investment which means locking up funds for a long period. Investors do not like to relinquish control over their savings for a long time. Hence, they are reluctant to invest in long-gestation projects. It is the presence of the liquid secondary market that attracts investors because it ensures a quick exit without heavy losses or costs.

Hence, the development of an efficient capital market is necessary for creating a climate conducive investment and economic growth.

### **Features of Capital Market**

1. **Deals in Long-term Funds** – Provides financing for more than one year, usually for long-term projects, expansion, and modernization.
2. **Wide Range of Instruments** – Includes shares, debentures, bonds, mutual funds, and government securities.
3. **Two Segments** – Divided into **primary market** (new issues of securities) and **secondary market** (stock exchanges where existing securities are traded).
4. **Link Between Savers and Investors** – Mobilizes savings from households and institutions and channels them into productive sectors.



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5. **Government Regulation** – Controlled and regulated by bodies like **SEBI** and the **Ministry of Finance** to ensure transparency and investor protection.
6. **Higher Risk & Return** – Compared to the money market, capital market instruments carry more risk but also provide higher returns.
7. **Liquidity through Stock Exchanges** – Provides liquidity as investors can sell securities in secondary markets at any time.

**Functions of Capital Market**

1. **Mobilization of Savings** – Collects idle savings from individuals and institutions and directs them into investment opportunities.
2. **Capital Formation** – Facilitates the conversion of savings into long-term investments, leading to industrial and economic growth.
3. **Efficient Allocation of Funds** – Ensures funds flow into the most productive and profitable sectors of the economy.
4. **Encourages Investment** – Provides a platform for investors to invest in a variety of securities according to their risk preference.
5. **Provides Liquidity** – Through stock exchanges, investors can easily convert securities into cash, which builds confidence.
6. **Helps Price Discovery** – Prices of securities are determined by demand and supply in the secondary market, reflecting real value.
7. **Supports Government Borrowing** – Enables governments to raise long-term funds through bonds and securities for infrastructure and welfare projects.

**Indian Capital Market**

The Indian Capital Market is a market for **long-term funds**, where companies, financial institutions, and the government raise capital through **shares, debentures, bonds, and government securities**. It has two segments: **Primary Market** (new issues) and **Secondary Market** (trading existing securities).

**Reforms:**

- Establishment of **SEBI** for regulation and investor protection.
- **Dematerialization of securities** and electronic trading.
- Introduction of **derivatives, mutual funds, and better corporate governance**.
- Liberalization for **foreign investment**.

**Defects:**

- Market **volatility and speculation**.
- **Low retail participation** and information asymmetry.
- **Regulatory gaps** and underdeveloped debt market.

**Solutions:**

- Promote **financial literacy** and retail participation.
- Strengthen **SEBI regulation and enforcement**.
- Develop **corporate bond and debt market**.
- Increase **transparency and technology adoption**.



## **Types of capital market**

There are two types of capital market:

- Primary market (New issue market)
- Secondary Market

## **Primary Market**

The **Primary Market**, also called the **New Issue Market (NIM)**, is a segment of the capital market where **new securities are issued for the first time** by companies, government, or financial institutions to raise **long-term funds**. It acts as a **bridge between savers and issuers**, converting savings into productive investment. Unlike the secondary market, which deals with trading existing securities, the primary market **directly provides funds to the issuing entity**.

According to **SEBI**:

*"The primary market is a market for new issues of shares, debentures, bonds, or any other securities, where companies raise capital directly from investors."*

**In simple terms:** It is the market where **investors purchase securities directly from the company or issuer for the first time**.

## **Features of Primary Market**

1. **New Issues Only** – Deals exclusively with **freshly issued securities**, not those already in circulation.
2. **Direct Fund Flow** – Money invested by investors goes **directly to the issuing company or institution**, helping it raise capital.
3. **Long-Term Capital** – Securities issued in the primary market are typically for **long-term funding**, such as **equity shares, preference shares, bonds, and debentures**.
4. **Methods of Issuance** – Includes **public issue, rights issue, private placement, and preferential allotment**.
5. **Regulated Market** – Governed by **SEBI** to protect investors, ensure transparency, and prevent fraud.
6. **Price Determination** – Securities can be issued at **par, discount, or premium** depending on company valuation and market conditions.
7. **Investment Opportunity** – Provides an opportunity for investors to **participate in the growth of a company** by buying its securities directly.
8. **Facilitates Capital Formation** – Helps the economy by channelizing **savings into productive investment** and promoting industrial growth.

## **Functions of Primary Market**

1. **Raising Long-Term Funds** – Helps companies, governments, and financial institutions raise funds for expansion, new projects, or debt repayment.
2. **Mobilization of Savings** – Converts household and institutional savings into productive investments.
3. **Facilitating Capital Formation** – Promotes industrialization and infrastructure growth by providing long-term finance.
4. **Price Determination** – Securities are issued at **par, discount, or premium**, depending on valuation and demand.



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5. **Wide Methods of Issue** – Offers various modes like public issue, rights issue, private placement, and preferential allotment.
6. **Regulation and Transparency** – Ensures investor protection through SEBI's supervision and disclosure norms.

**Importance of Primary Market**

1. **Supports Economic Development** – By financing industries and infrastructure, it boosts GDP growth.
2. **Encourages Investment** – Offers diverse instruments, attracting small and large investors.
3. **Provides Direct Access to Investors** – Companies get funds without intermediaries, strengthening financial stability.
4. **Strengthens Financial System** – Works with secondary markets and institutions to build a strong capital market.
5. **Promotes Entrepreneurship** – New businesses and startups can raise capital for innovation and expansion.

## **Methods of Issuing Securities in the Primary Market**

When a company requires long-term funds for expansion, new projects, or repayment of debt, it raises capital by issuing securities in the **Primary Market**. There are several important methods through which these securities can be issued.

### **1. Public Issue through Prospectus**

This is the most widely used and traditional method of raising funds in the primary market. A company invites the **general public** to subscribe to its shares or debentures by issuing a **prospectus**. A prospectus is a detailed legal document that provides complete information about the company, such as its background, financial performance, purpose of raising funds, terms of the issue, risks involved, and application procedures. Investors can apply directly for these securities, and the funds collected go straight to the company. This method is generally used in **Initial Public Offers (IPOs)** and **Follow-on Public Offers (FPOs)**. While it ensures wide participation from investors, it is also costly and time-consuming due to strict regulatory requirements by SEBI.

### **2. Private Placement**

In a private placement, the company does not approach the general public but instead offers its securities to a **select group of investors**, such as financial institutions, banks, insurance companies, venture capitalists, or high-net-worth individuals. This method is advantageous because it is faster, involves lower costs, and requires less compliance compared to a public issue. Private placement is especially popular with startups, growing companies, or businesses that want to raise funds without undergoing the lengthy process of a prospectus issue. However, since the number of investors is limited, the amount of capital raised is generally smaller than a public issue.

### **3. Offer for Sale**

In this method, the company issues securities not directly to the public but to an **intermediary**, such as brokers, underwriters, or financial institutions, at a pre-decided price. These intermediaries then resell the securities to the public at a higher price. The difference between the purchase price and the selling price is their profit margin. This method saves the company from the administrative burden of approaching the public directly and handling subscription formalities. It is particularly useful for companies that do not want to incur the high costs of public issues or wish to raise funds more quickly. However, it depends heavily on the efficiency and reputation of intermediaries in distributing the securities to investors.



#### **4. Rights Issue**

A rights issue is an offer made by a company to its **existing shareholders** to purchase additional shares in proportion to their current shareholding. For example, if a shareholder holds 100 shares and the company announces a rights issue of 1:10, the shareholder has the right to buy 10 more shares. Rights issues are usually offered at a price lower than the prevailing market price, making them attractive to shareholders. This method helps companies raise additional capital while ensuring that the control of ownership remains in the hands of existing investors. It also gives shareholders the first right to maintain their proportional ownership in the company.

#### **5. Bonus Shares**

Bonus shares are shares issued by a company to its existing shareholders **free of cost**, in proportion to the number of shares they already hold. Unlike other methods, bonus shares do not raise fresh capital for the company; instead, they are issued by converting a part of the company's **accumulated profits, reserves, or retained earnings** into share capital. For example, if a company declares a bonus issue of 1:5, then a shareholder holding 50 shares will receive 10 additional shares at no cost. Bonus shares are a way of rewarding shareholders, increasing their confidence in the company, and improving the liquidity of shares in the market. They also signal financial strength, which often has a positive impact on the company's stock price.

### **Secondary Market**

The **Secondary Market**, also called the **Stock Market** or **Stock Exchange**, is the segment of the capital market where **already issued securities are bought and sold among investors**. Unlike the primary market, where companies raise fresh funds by issuing new securities, the secondary market does not provide capital to the issuing company directly. Instead, it provides **liquidity and tradability** to investors by enabling them to resell their securities at any time. It acts as a platform where investors can **exit or enter an investment easily**, making financial assets more attractive. The two most prominent stock exchanges in India are the **Bombay Stock Exchange (BSE)** and the **National Stock Exchange (NSE)**.

According to the **Securities Contract (Regulation) Act, 1956**:

*"Stock Exchange means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating, or controlling the business of buying, selling or dealing in securities."*

Hence, the Secondary Market is a platform where investors trade existing securities such as shares, debentures, and bonds with one another, ensuring liquidity and continuous price discovery.

#### **Features of Secondary Market**

1. **Deals in Existing Securities** – Only those securities that were previously issued in the primary market are traded here.
2. **Provides Liquidity** – Investors can convert their securities into cash easily by selling them in the stock exchange.
3. **Price Determination** – Prices of securities are determined by **demand and supply forces** in the market, ensuring continuous price discovery.
4. **Regulated Market** – Secondary markets are strictly regulated by **SEBI (Securities and Exchange Board of India)** to ensure transparency, investor protection, and fair trading.
5. **Organized Trading** – Conducted through stock exchanges with well-defined rules, electronic trading systems, and settlement procedures.
6. **Wide Range of Participants** – Involves investors, brokers, dealers, financial institutions, and FIIs/FPIs.
7. **Encourages Investment** – By offering an easy exit route to investors, it makes securities more attractive for investment in the primary market.



### **Functions of Secondary Market**

1. **Liquidity and Marketability of Securities** – Provides investors with the opportunity to sell their securities at any time, making investments less risky and more flexible.
2. **Price Discovery** – Continuously determines the value of securities based on supply and demand, helping investors and companies know the true market worth.
3. **Capital Formation** – By offering liquidity and encouraging investors to buy securities, it indirectly promotes capital formation in the economy.
4. **Risk Transfer** – Investors who want to reduce risk can sell their securities, while others who are willing to take risks can buy them, leading to an efficient transfer of risk.
5. **Promotes Savings and Investment** – Encourages households and institutions to invest in financial assets, as they can liquidate them whenever required.
6. **Investor Protection** – By being regulated under SEBI, it ensures fair practices, prevents insider trading, and protects the rights of investors.
7. **Helps Economic Growth** – By facilitating the flow of funds and ensuring that resources move toward profitable and efficient enterprises, the secondary market boosts economic development.

### **Importance of Secondary Market**

1. **Provides Liquidity** – Investors can easily convert their securities into cash, making financial investments more attractive compared to physical assets like land or gold.
2. **Encourages Primary Market Growth** – Since investors know they can sell securities anytime, they are more willing to subscribe to new issues in the primary market.
3. **Efficient Resource Allocation** – Capital flows toward companies with better performance, ensuring optimum use of resources.
4. **Promotes Investor Confidence** – Transparent regulations, continuous trading, and fair pricing build confidence among investors, both domestic and foreign.
5. **Facilitates Government Borrowing** – The government can raise funds by issuing securities, which become more attractive due to the liquidity offered in secondary markets.
6. **Economic Indicator** – Stock market trends often reflect the overall performance of the economy and investor sentiment, making it a barometer of economic health.
7. **Encourages Innovation and Entrepreneurship** – By providing liquidity and access to funds, the secondary market indirectly supports startups and businesses, motivating them to innovate and grow.

### **Conclusion**

The **Secondary Market** is the backbone of financial markets because it provides **liquidity, price discovery, investor protection, and efficient allocation of capital**. It complements the primary market by making securities attractive to investors and ensures that savings are continuously directed toward the most productive uses. By boosting investor confidence and channelizing funds into growth-oriented enterprises, the secondary market plays a crucial role in the **economic development of a nation**.



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## **7 HISTORY OF THE INDIAN CAPITAL MARKET**

The history of the capital market in India dates back to the eighteenth century when East India Company. Securities were traded in the country, Until the end of the nineteenth century, securities trading was unorganised and the main trading centres were Bombay (now Mumbai) and Calcutta (now Kolkata). Of the two, Bombay was the chief trading centre wherein bank shares were the major trading stock. During the American Civil War (1860-61), Bombay was an important source of supply for cotton. Hence, trading activities flourished during the period, resulting in a boom in share prices. This boom, the first in the history of the Indian capital market, lasted for a half a decade. The bubble burst on July 1, 1865, when there was tremendous slump in share prices

The capital market was not well organised and developed during the British rule because the British government was not interested in the economic growth of the country. As a result, many foreign companies depended on the London capital market for funds rather than on the Indian capital market. In the post-independence period also, the size of the capital market remained small. During the first and second five year plans, the government's emphasis was on the development of the agricultural sector and public sector undertakings. The public sector undertakings were healthier than the private undertakings in as of paid up capital but their shares were not listed on the stock exchanges. Moreover, the Controller of Capital Issues (CCI) closely supervised and controlled the timing, composition, interest rates, pricing, allotment. And floatation costs of new issues. These strict regulations demotivated many companies from going public for almost four and a half decades. The 1950s, Century Textiles, Tata Steel, Bombay Dyeing, National Rayon, and Kohinoor Mills were the favourite scrips of speculators. As speculation became rampant, the stock market came to be known as Seta Bazaar

Despite speculation, non-payment or defaults were not very frequent. The government enacted Securities Contracts (Regulation) Act in 1956 to regulate stock markets. The Companies Act, 1956 also enacted. The decade of the 1950s was also characterised by the establishment of a network for the development of financial institutions and state financial corporation.

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, 1947 was repealed in May 1992. The decade was characterised by a new liberalisation policy, emergence of SEBI as a regulator of capital market, advent of foreign institutional investors, free pricing, new trading practices, new stock exchanges, entry of new players such as private sector mutual funds and private sector banks, and primary market boom and bust.

Major capital market scams took place in the 1990s. These shook the capital market and drove away small investors from the market. The securities scam of March 1992 involving brokers as well as bankers was one of the biggest scams in the history of the capital market. In the subsequent years owing to free pricing many unscrupulous promoters, who raised money from the capital market, proved to be fly-by-night operators. This led to an erosion in the investors' confidence. The M S Shoes case, one such scam which took place in March 1995, put a break on new issue activity.

### **A brief history of the rise of equity trading in India**

**July 9, 1875:** Native brokers form the Native Share and Stock Brokers' Association in Bombay. Membership fee is Re. 1. The association has 318 members.

**1899:** Bombay Stock Exchange acquires own premises.

**1921:** Clearing houses are established for settlement of trades as volumes increase.

**1923:** K R P Shroff becomes the honorary president of BSE. **1925:** Bombay Securities Contract Control Act (BSCCA) comes into force. **December 1, 1939:** Stock exchange building is acquired.



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**1943:** Forward trading banned till 1946. Only ready to deliver and hand delivery contracts permitted. 1956: Securities Contract Regulation 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

**June 29, 1969:** Morarji Desai bans forward trading.

**1973:** Construction of PI Towers, named after late Phiroze Jamshedji Jeejeebhoy, starts.

**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 (SEBI) set up.

**January 1992:** SEBI 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 repealed.

**September 1992:** Foreign institutional investors are permitted to invest in the Indian securities market.

**November 1992:** Finance Minister Manmohan Singh inaugurates Over the Counter Exchange of India.

**October 30, 1993:** The first private sector mutual fund. Kothari Pioneer Mutual Fund, begins operations.

**November 1993:** SEBI bans badla trading on BSE

**November 1994:** The capital market segment INSE goes on stream. Trading is screen based for the first time in India.

**March 1995:** BSE on line trading system (BOLT) replaces open outcry system. April 1995: The National Securities Clearing Corporation Limited, India's first clearing corporation is set up.

**October 1995:** NSE overtakes BSE as the largest stock exchange in terms of volume of trading

**April 1996:** Nifty is born. The National Securities Clearing Corporation Limited commences operations.

**November 1996:** The National Securities Depository Limited is created.

**May 1997:** BSE introduces screen based trading.

**February 1997:** SEBI releases norms for takeovers and acquisitions.

**November 1998:** SEBI recognises Interconnected Stock Exchange founded by 15 regional stock exchanges. This exchange starts functioning in February 1999

**February 1998:** Launch of automated lending and borrowing mechanism (ALBM) on NSE.

**March 11, 1999:** Infosys Technologies is the first company to be listed on NASDAQ through a public offering of American Depository Receipts.

**March 22, 1999:** Central Depository Services (India) promoted by BSE commences operations.

**September 1999:** ICICI is the first Indian company to be listed on the New York Stock Exchange (NYSE)

**October 11, 1999:** For the first time in BSE's history, the Sensex closes above the 5,000 mark at 5,031.78.

**January 2000:** BSE creates a 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 14, 2000, BSE sensex hits all-time high of 6,150. On February 21, NSE records peak market capitalisation of Rs 11,94,282 crore.

**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.

**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.

**May 2001:** BSE advises compulsory demat for B2 scrips.

**June 2001:** Index options started trading on NSE.



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### **SEBI Meaning**

- SEBI full form is Securities and Exchange Board of India
- SEBI is a statutory regulatory body established by the Government of India to regulate the securities market in India and protect the interests of investors in securities.
- It also regulates the functioning of the stock market, mutual funds, etc.

### **What is SEBI and its functions?**

The Securities and Exchange Board of India (Sebi) is a statutory regulatory body established by the Government of India in 1992 to regulate the securities market in India and protect the interests of investors in securities.

SEBI has the power to regulate and perform functions such as check the books of accounts of stock exchanges and call for periodical returns, approve by-laws of stock exchanges, inspect the books of financial intermediaries such as banks, compel certain companies to get listed on one or more stock exchanges, and handle the registration of brokers.

### **Why is SEBI formed?**

#### **Purpose of SEBI**

SEBI was established to keep a check on unfair and malpractices and protect the investors from such malpractices. The organization was created to meet the requirements of the following three groups:

- Issuers: SEBI works toward providing a marketplace to the investors where they can efficiently and fairly raise their funds.
- Intermediaries: SEBI works towards providing a professional and competitive market to the intermediaries
- Investors: SEBI protects and supplies accurate information to investors.

### **Objectives of SEBI**

The fundamental objective of SEBI is to safeguard the interest of all the parties involved in trading. It also regulates the functioning of the stock market. SEBI's objectives are:

- To monitor the activities of the stock exchange.
- To safeguard the rights of the investors
- To curb fraudulent practices by maintaining a balance between statutory regulations and self-regulation.
- To define the code of conduct for the brokers, underwriters, and other intermediaries.

### **Powers of SEBI**

SEBI carries out the following tasks to meet its objectives: Protective functions, Regulatory functions, and developmental functions.

Functions that SEBI performs as a part of its **protective functions** are:

- It checks price manipulation
- It bans Insider trading
- It prohibits unfair and fraudulent trade practices
- It promotes a fair code of conduct in the security market
- It takes efforts to educate the investors regarding ways to evaluate the investment options better

As a part of its **regulatory functions**, SEBI performs the following role:



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- It has designed a code of conduct, rules, and regulations to regulate the brokers, underwriters, and other intermediaries.
- SEBI also governs a company's takeover.
- It regulates and registers the workings of share transfer agents, stockbrokers, merchant bankers, trustees, and others who are linked with the stock exchange.
- It regulates and registers the mutual funds as well.
- It conducts audits and inquiries of stock exchanges.

As a part of its **developmental functions**, SEBI performs the following role:

- It facilitates the training of the intermediaries.
- It aims at promoting activities of the stock exchange by having an adoptable and flexible approach.

### Structure of SEBI

The Board of SEBI comprises of nine members. The Board is an aggregate of the following:

1. One Chairman of the board – appointed by the Central Government of India
2. One Board member – appointed by the Central Bank, that is, the RBI
3. Two Board members – hailing from the Union Ministry of Finance
4. Five Board members – elected by the Central Government of India

The Chairman of SEBI, in addition to overseeing the Board, also looks over the Communications, Vigilance, and Internal Inspection Department.

There are four whole-time members in the organizational structure. The whole-time members are allocated a number of departments that they have to oversee. Each department is individually headed by an executive director. The executive directors report to specific whole-time members.

The organizational structure of SEBI consists of more than 25 departments, such as Foreign Portfolio Investors and Custodians (FPI&C), Corporation Finance Department (CFD), Information Technology Department (ITD), Department of Economic and Policy Analysis (DEPA-I,II, & III), Investment Management Department, Legal Affair Department, Treasury and Accounts Divisions (T&A), and National Institute of Securities Market (NISM)

### SEBI Act and SEBI Guidelines

SEBI was established as a non-statutory body in 1988, entrusted with observing the stock market activities. The SEBI Act of 1992 converted SEBI into a statutory authority with autonomous powers. The Act provided SEBI with the authority to regulate capital markets, not just observe but enforce guidelines.

The SEBI Act 1992 covers the following areas:

- Composition and actions of the SEBI Board members
- Powers and Functions of the Board
- Fund sources of SEBI, as in grants made available by the Union Government
- Rules on Penalties and legal pathways
- Defines the judicial authority of SEBI
- The extent of powers of the Union Government to supersede SEBI

SEBI also has to adhere to a list of SEBI guidelines, pertaining to areas such as:



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- Employee Stock Option schemes
- Disclosure and Investor Protection norms
- Legal Proceedings
- Anti-money laundering norms
- Listing and delisting of securities
- Opening of trading terminals overseas

### SEBI LODR regulations 2015

Listing Obligations and Disclosure Requirements (LODR) regulations for SEBI form one of the most important mandates. The regulation covers the extent of transparency and disclosures that listed companies have to abide by. In addition to the compulsory disclosure norms, the regulation also refines the listing agreement, which has to be entered between the stock exchange and the companies being listed.

The agreement consists of terms and conditions on governance, disclosures, and terms to maintain the listing status of the company. However, the new regulation in 2015 on LODR intends to consolidate all the previous amendments into one single document, making the document uniform across different segments of the capital market.

The SEBI (LODR) Regulations, 2015 entails the following:

- Disclosures and obligations that have to be acknowledged by the compliance officers of the listed company
- Listing down obligations uniform to all listed companies
- Distinct obligations for certain types of securities
- Segregating initial issuance and post-IPO norms
- Communication of the companies' fundraising activities
- Establishing timelines for notifying the exchanges of certain events
- Bringing SMEs under the ambit of the SEBI (LODR) Regulations

For a complete list of regulations that govern the market regulator, click [here](#).

### SEBI New Margin Rules

In September 2020, SEBI implemented new rules on margin pledge. The rule is expected to bring transparency and prevent misuse of clients' securities by brokerage firms. The new margin rules were directed to come into effect from June 1, but were delayed due to pandemic pushing the implementation date to September 1.

The new margin rules by SEBI mandate the following:

- The stock, being pledged, is to remain in the investor's de-mat account. As the stock is not changing accounts, the benefits from corporate events accrue directly to the investors
- Upfront collection of margins by brokers for any purchase or sale of securities, penalizing any sort of failure to do so. Clients could meet the margin requirements by the end of the day, which is now changed to the beginning of the day
- Power of Attorney (POA) cannot be assigned in the favour of the brokers for pledging. As under the old system, brokers could demand POA from the investors to execute decisions on their behalf



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- Margin pledge created separately for investors requiring margin
- Buy Today Sell Tomorrow (BTST) not allowed anymore for shares bought on margin. Investors are required to honor the delivery of share (T+2 days is the usual settlement period). Typically, investors would use intraday realized profits to meet the margin requirements, which is now amended by the new regulations. For a BTST trade, it can be initiated only if the net available margin is equal to or greater than 20 percent of the transaction value.

## **Mutual Funds**

A mutual fund is a company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt. The combined holdings of the mutual fund are known as its portfolio. Investors buy shares in mutual funds. Each share represents an investor's part ownership in the fund and the income it generates.

Mutual funds are a popular choice among investors because they generally offer the following features:

- Professional Management. The fund managers do the research for you. They select the securities and monitor the performance.
- Diversification or "Don't put all your eggs in one basket." Mutual funds typically invest in a range of companies and industries. This helps to lower your risk if one company fails.
- Affordability. Most mutual funds set a relatively low dollar amount for initial investment and subsequent purchases.
- Liquidity. Mutual fund investors can easily redeem their shares at any time, for the current net asset value (NAV) plus any redemption fees.

### **Importance of mutual funds.**

Most mutual funds fall into one of four main categories – money market funds, bond funds, stock funds, and target date funds. Each type has different features, risks, and rewards.

- Money market funds have relatively low risks. By law, they can invest only in certain high-quality, short-term investments issued by U.S. corporations, and federal, state and local governments.
- Bond funds have higher risks than money market funds because they typically aim to produce higher returns. Because there are many different types of bonds, the risks and rewards of bond funds can vary dramatically.
- Stock funds invest in corporate stocks. Not all stock funds are the same. Some examples are:
  - Growth funds focus on stocks that may not pay a regular dividend but have potential for above-average financial gains.
  - Income funds invest in stocks that pay regular dividends.
  - Index funds track a particular market index such as the Standard & Poor's 500 Index.
  - Sector funds specialize in a particular industry segment.
- Target date funds hold a mix of stocks, bonds, and other investments. Over time, the mix gradually shifts according to the fund's strategy. Target date funds, sometimes known as lifecycle funds, are designed for individuals with particular retirement dates in mind.

### **Benefits and risks of mutual funds.**

Mutual funds offer professional investment management and potential diversification. They also offer three ways to earn money:



- **Dividend Payments.** A fund may earn income from dividends on stock or interest on bonds. The fund then pays the shareholders nearly all the income, less expenses.
- **Capital Gains Distributions.** The price of the securities in a fund may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, the fund distributes these capital gains, minus any capital losses, to investors.
- **Increased NAV.** If the market value of a fund's portfolio increases, after deducting expenses, then the value of the fund and its shares increases. The higher NAV reflects the higher value of your investment.

All funds carry some level of risk. With mutual funds, you may lose some or all of the money you invest because the securities held by a fund can go down in value. Dividends or interest payments may also change as market conditions change.

A fund's past performance is not as important as you might think because past performance does not predict future returns. But past performance can tell you how volatile or stable a fund has been over a period of time. The more volatile the fund, the higher the investment risk.

### **Process to Purchase and sell mutual funds**

Investors buy mutual fund shares from the fund itself or through a broker for the fund, rather than from other investors. The price that investors pay for the mutual fund is the fund's per share net asset value plus any fees charged at the time of purchase, such as sales loads.

Mutual fund shares are "redeemable," meaning investors can sell the shares back to the fund at any time. The fund usually must send you the payment within seven days.

Before buying shares in a mutual fund, read the prospectus carefully. The prospectus contains information about the mutual fund's investment objectives, risks, performance, and expenses.

### **Understanding fees**

As with any business, running a mutual fund involves costs. Funds pass along these costs to investors by charging fees and expenses. Fees and expenses vary from fund to fund. A fund with high costs must perform better than a low-cost fund to generate the same returns for you.

Even small differences in fees can mean large differences in returns over time. For example, if you invested \$10,000 in a fund with a 10% annual return, and annual operating expenses of 1.5%, after 20 years you would have roughly \$49,725. If you invested in a fund with the same performance and expenses of 0.5%, after 20 years you would end up with \$60,858.

It takes only minutes to use a mutual fund cost calculator to compute how the costs of different mutual funds add up over time and eat into your returns. See the Mutual Fund Glossary for types of fees.

### **Avoiding fraud**

By law, each mutual fund is required to file a prospectus and regular shareholder reports with the SEC. Before you invest, be sure to read the prospectus and the required shareholder reports. Additionally, the investment portfolios of mutual funds are managed by separate entities known as "investment advisers" that are registered with the SEC. Always check that the investment adviser is registered before investing.



## **Regulation of mutual funds in India**

The name itself suggests that a '**Mutual fund**' is like an investment channel that helps several investors to combine their resources to purchase stocks, bonds, and other securities for their earnings.

These combined funds which are referred to as **Assets Under Management** (AUM) are then invested in a mutual fund company's manager who has expertise in it. The mutual fund company is called as an **Asset Management Company** (AMC).

This combined underlying holding of the fund is called the '**portfolio**' and each investor owns some portion of this portfolio and this portion which the person holds is in the form of units.

### **History of mutual funds in India**

- In India, the industry dealing with mutual funds was established in the year **1963** with the development of the **Unit Trust of India** (UTI) which was an initiative of the Indian government and the Reserve Bank of India.
- The SBI Mutual Fund became the first NON-UTI mutual fund in India in the year 1987.
- The year 1993 heralded a new era in this industry of mutual funds as it was marked by the entry of private companies.
- The SEBI Mutual Fund Regulations came into being in 1996 after the passing of the Securities and Exchange Board of India (SEBI) Act of 1992.
- After this, the Mutual fund companies have extended and grown exponentially with the help of foreign institutions setting companies in India through joint ventures and properties.
- The **Association of Mutual Funds in India** (AMFI), a non-profit organization, was founded in 1995 as the industry developed. It was formed with the objective of promoting healthy and ethical marketing practices in the mutual fund industry of India.
- SEBI has made the certificate of AMFI mandatory for all those who are engaged in marketing mutual fund products.

### **Objective of mutual funds**

The objectives of mutual funds are as follows:

- It helps in generating an additional source of income other than the general earnings.
- It helps in financing some of the future needs a person dreams of, such as buying a home, post-retirement plans, education of children and their education, legacy planning, etc.
- It can help in increasing the savings a person possesses.
- It is useful in reducing tax liabilities.
- It helps in protecting your savings from inflation.

A mutual fund is a commercial product that invests in stocks or bonds.

A mutual fund is a pool of investment which is managed professionally for the purpose of purchasing various securities and culminating them into a strong portfolio that will give you attractive returns over and it will be above the risk-free returns which are currently being offered by the market.

If you own a mutual fund then it is like getting a slice of an apple. Just like that the investors get units of the fund which are in proportion to their investments.



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For example, if there is a mutual fund that has total assets of \$5000 and someone invests \$500, he/she will receive 10% units of that fund.

### Mutual funds meaning

- **Mutual Fund** is like a financial vehicle that consists of all the money collected from different investors in securities such as stocks, bonds, and assets.
- It is operated by money managers who allocate the fund's assets and produce income for the fund's investors.
- It gives investors access to diversified portfolios at a low price.
- It is divided into several kinds of categories on the basis of investment objectives, kinds of securities they invest in, and the type of return they are expecting.
- It charges annual fees known as expense ratio or in some cases commissions.

### Regulation of Mutual Funds in India

The term "**regulation**" means a rule or directive made and controlled by an authority.

- Mutual funds are regulated by the **Securities and Exchange Board of India (SEBI)**.
- In 1996, SEBI formulated the Mutual Fund Regulation.
- SEBI is additionally the apex regulator of capital markets and its intermediaries.
- The issuance and trading of capital market instruments also come under the purview of SEBI.
- Along with SEBI, mutual funds are regulated by RBI, Companies Act, Stock exchange, Indian Trust Act and Ministry of Finance.
- RBI acts as a regulator of Sponsors of bank-sponsored mutual funds, especially in the case of funds offering guaranteed returns.
- In order to provide a guaranteed returns scheme, a mutual fund needs to take approval from RBI.
- The Ministry of Finance acts as a supervisor of RBI and SEBI and appellate authority under SEBI regulations.
- Mutual funds can appeal to the Ministry of finance on the SEBI rulings.

### Who regulates mutual funds in India

- Primarily, mutual funds are regulated by the Securities and Exchange Board of India (SEBI).
- A mutual fund should have the approval of RBI in order to provide a guaranteed returns scheme.
- The Ministry of Finance acts as a supervisor of RBI and SEBI and appellate authority under SEBI regulations.
- The Association of Mutual Funds in India (AMFI) has been made to develop this Mutual Fund Industry of India on professional and ethical lines and to enhance and maintain standards in all areas with a view to protect and promote the interests of mutual funds and their unitholders.



## Advantages of mutual funds

- It offers you professional management. Through mutual funds, investors get access to the professional money managers who have expertise and experience in the field of buying, selling and monitoring investments by the investors.
- It helps you in holding a wide variety of shares at a much lower price than you really could own by yourself. If one investment in the Fund decreases in value that does not mean that the other will also be decreased, it may increase as well. By holding shares in the market you can take advantage of the changing environment in the industry. It helps in diversification.
- It gives opportunities to the small investors to take part in the professional asset management and they can have low investment minimums.
- Most of the mutual funds allow investors to deal with shares on any business day. Many funds provide you with an automatic purchase program. It is according to the convenience of the investors and helps them in gaining the best out of the money invested.

## Mutual fund benefits

There are various benefits of investing in Mutual Funds, such as:

- The higher level of diversification since the basket of a portfolio will be aimed at spreading the investment in order to offer protection against concentration risks.
- They provide regular liquidity as shareholders of open-ended funds and unit investment trusts may sell their holdings back to the fund at regular intervals at a price equal to the NAV of the fund's holdings.
- Managed by professional investors who have rich experience in investment and can understand the nerves of the market.
- Since mutual funds are regulated by a Government body i.e. AMFI in India, it offers protection and comfort to the investors before considering investment opportunity.
- All mutual funds are required to report the same level of information to the investors which makes it relatively easier for comparison in case of diversification.
- These funds provide regular reports of their performance and are also easily available on the internet to understand past trends as well as the strategies implemented.

## Investing mutual funds in India

- After submitting an application form along with a cheque or bank draft at the branch office or designated Investor Service Centres (ISC) of mutual Funds or Registrar & Transfer Agents one can invest in mutual funds.
- Investment can also be made online through the websites of the respective mutual funds.
- One may also invest through a Mutual Fund Distributor registered with AMFI or choose to invest directly.
- A Mutual Fund Distributor can be – an individual or a non-individual entity e.g. Banks etc.



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**Association of mutual funds in India**

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The Association of Mutual Funds in India has been established to develop the industry of Mutual funds in India. Its aim is to make this industry on professional, ethical and healthy lines. This is done to enhance this industry and maintain standards so that the interests of the shareholders are promoted and protected.

AMFI was incorporated on 22<sup>nd</sup> August 1995 as a non-profit organization.

It is an association of SEBI registered mutual funds in India of all the registered Asset Management Companies.

## **Financial Instruments**

### **INTRODUCTION TO DERIVATIVES**

The emergence of the market for derivative products, most notably forwards, futures and options, can be traced back to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. By their very nature, the financial markets are marked by a very high degree of volatility. Through the use of derivative products, it is possible to partially or fully transfer price risks by locking in asset prices. As instruments of risk management, these generally do not influence the fluctuations in the underlying asset prices. However, by locking in asset prices, derivative products minimize the impact of fluctuations in asset prices on the profitability and cash flow situation of risk-averse investors.

### **DERIVATIVES DEFINED**

Derivative is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index, or reference rate), in a contractual manner. The underlying asset can be equity, forex, commodity or any other asset. For example, wheat farmers may wish to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such a transaction is an example of a derivative. The price of this derivative is driven by the spot price of wheat which is the “underlying”.

In the Indian context the Securities Contracts (Regulation) Act, 1956 (SCRA) defines “derivative” to include

1. A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.



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2. A contract which derives its value from the prices, or index of prices, of underlying securities. Derivatives are securities under the SC(R)A and hence the trading of derivatives is governed by the regulatory framework under the SC(R)A.

#### **EMERGENCE OF FINANCIAL DERIVATIVE PRODUCTS**

Derivative products initially emerged as hedging devices against fluctuations in commodity prices, and commodity-linked derivatives remained the sole form of such products for almost three hundred years. Financial derivatives came into spotlight in the post-1970 period due to growing instability in the financial markets. However, since their emergence, these products have become very popular and by 1990s, they accounted for about two-thirds of total transactions in derivative products. In recent years, the market for financial derivatives has grown tremendously in terms of variety of instruments available, their complexity and also turnover. In the class of equity derivatives the world over, futures and options on stock indices have gained more popularity than on individual stocks, especially among institutional investors, who are major users of index-linked derivatives. Even small investors find these useful due to high correlation of the popular indexes with various portfolios and ease of use

#### **FACTORS DRIVING THE GROWTH OF DERIVATIVES**

Over the last three decades, the derivatives market has seen a phenomenal growth. A large variety of derivative contracts have been launched at exchanges across the world. Some of the factors driving the growth of financial derivatives are:

1. Increased volatility in asset prices in financial markets,
2. Increased integration of national financial markets with the international markets,
3. Marked improvement in communication facilities and sharp decline in their costs,



4. Development of more sophisticated risk management tools, providing economic agents a wider choice of risk management strategies, and
5. Innovations in the derivatives markets, which optimally combine the risks and returns over a large number of financial assets leading to higher returns, reduced risk as well as transactions costs as compared to individual financial assets.

### **DERIVATIVE PRODUCTS**

Derivative contracts have several variants. The most common variants are forwards, futures, options and swaps. We take a brief look at various derivatives contracts that have come to be used.

#### **Forwards:**

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

#### **Futures:**

A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange-traded contracts.

#### **Options:**

Options are of two types – calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date. Warrants: Options generally have lives of upto one year, the majority of options traded on options exchanges having a maximum maturity of nine months. Longer-dated options are called warrants and are generally traded over-the-counter.

#### **LEAPS:**

The acronym LEAPS means Long-Term Equity Anticipation Securities. These are options having a maturity of upto three years.

#### **Baskets:**

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

#### **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 commonly used swaps are:

- Interest rate swaps: These entail swapping only the interest related cash flows between the parties in the same currency.
- Currency swaps: These entail swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than those in the opposite direction.

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

#### **PARTICIPANTS IN THE DERIVATIVES MARKETS**

The following three broad categories of participants – hedgers, speculators, and arbitrageurs trade in the derivatives market. Hedgers face risk associated with the price of an asset. They use futures or options markets to reduce or eliminate this risk. Speculators wish to bet on future movements in the price of an asset. Futures and options contracts can give them an extra leverage; that is, they can increase both the potential gains and potential losses in a speculative venture. Arbitrageurs are in business to take advantage of a discrepancy between prices in two different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

#### **ECONOMIC FUNCTION OF THE DERIVATIVE MARKET**

In spite of the fear and criticism with which the derivative markets are commonly looked at, these markets perform a number of economic functions.

1. Prices in an organized derivatives market reflect the perception of market participants about the future and lead the prices of underlying to the perceived future level. The prices of derivatives converge with the prices of the underlying at the expiration of the derivative contract. Thus derivatives help in discovery of future as well as current prices.
2. The derivatives market helps to transfer risks from those who have them but may not like them to those who have an appetite for them.
3. Derivatives, due to their inherent nature, are linked to the underlying cash markets. With the introduction of derivatives, the underlying market witnesses higher trading volumes because of



participation by more players who would not otherwise participate for lack of an arrangement to transfer risk.

4. Speculative trades shift to a more controlled environment of derivatives market. In the absence of an organized derivatives market, speculators trade in the underlying cashmarkets. Margining, monitoring and surveillance of the activities of various participants become extremely difficult in these kind of mixed markets.

#### **History of derivatives markets**

Early forward contracts in the US addressed merchants' concerns about ensuring that there were buyers and sellers for commodities. However 'credit risk' remained a serious problem. To deal with this problem, a group of Chicago businessmen formed the Chicago Board of Trade (CBOT) in 1848. The primary intention of the CBOT was to provide a centralized location known in advance for buyers and sellers to negotiate forward contracts. In 1865, the CBOT went one step further and listed the first 'exchange traded' derivatives contract in the US, these contracts were called 'futures contracts'. In 1919, Chicago Butter and Egg Board, a spin-off of CBOT, was reorganized to allow futures trading. Its name was changed to Chicago Mercantile Exchange (CME). The CBOT and the CME remain the two largest organized futures exchanges, indeed the two largest "financial" exchanges of any kind in the world today.

The first stock index futures contract was traded at Kansas City Board of Trade. Currently the most popular stock index futures contract in the world is based on S&P 500 index, traded on Chicago Mercantile Exchange. During the mid eighties, financial futures became the most active derivative instruments generating volumes many times more than the commodity futures. Index futures, futures on T-bills and Euro-Dollar futures are the three most popular futures contracts traded today. Other popular international exchanges that trade derivatives are LIFFE in England, DTB in Germany, SGX in Singapore, TIFFE in Japan, MATIF in France, Eurex etc.



#### EXCHANGE-TRADED vs. OTC DERIVATIVES MARKETS

**Exchange-Traded Derivatives** are derivative contracts such as **futures and options** that are standardized and traded through an **organized exchange** (like NSE, BSE, CME). They are regulated by SEBI in India and involve a clearinghouse that guarantees settlement, which reduces counterparty risk.

**OTC Derivatives** are privately negotiated contracts between two parties, without going through an organized exchange. Common examples include **forwards, swaps, customized options**. These are flexible and tailor-made but carry higher counterparty risk.

### Key Differences Between Exchange-Traded and OTC Derivatives

| Basis                    | Exchange-Traded Derivatives          | OTC Derivatives                                    |
|--------------------------|--------------------------------------|----------------------------------------------------|
| <b>Trading Platform</b>  | Organized exchanges (NSE, BSE, CME)  | Direct negotiation between parties                 |
| <b>Standardization</b>   | Standardized contracts               | Customized contracts                               |
| <b>Counterparty Risk</b> | Minimal (clearinghouse guarantees)   | High (depends on the parties involved)             |
| <b>Transparency</b>      | High (prices are public)             | Low (private agreements)                           |
| <b>Liquidity</b>         | High due to large volumes            | Low, harder to exit                                |
| <b>Regulation</b>        | Highly regulated by SEBI/authorities | Less regulated, though supervised post-2008 crisis |



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### **Difference Between Money Market and Capital Market**

| <b>Basis</b>        | <b>Money Market</b>                                                                       | <b>Capital Market</b>                                                                     |
|---------------------|-------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------|
| <b>Meaning</b>      | Market for short-term funds where instruments with maturity less than 1 year are traded.  | Market for long-term funds where securities with maturity of more than 1 year are traded. |
| <b>Time Horizon</b> | Short-term (up to 1 year).                                                                | Long-term (more than 1 year, even perpetual).                                             |
| <b>Instruments</b>  | Treasury bills, call money, commercial paper, certificates of deposit, bills of exchange. | Shares, debentures, bonds, mutual funds, government securities.                           |
| <b>Objective</b>    | Provides liquidity and short-term financing to borrowers.                                 | Provides capital for long-term investment and development.                                |
| <b>Risk</b>         | Low risk (due to short-term maturity).                                                    | Relatively higher risk (due to long-term investment).                                     |
| <b>Return</b>       | Lower returns compared to capital market.                                                 | Higher returns possible due to long-term nature.                                          |
| <b>Participants</b> | RBI, commercial banks, financial institutions, NBFCs, mutual funds.                       | Companies, investors, stock exchanges, FIIs, retail investors, SEBI.                      |
| <b>Regulator</b>    | Reserve Bank of India (RBI).                                                              | Securities and Exchange Board of India (SEBI).                                            |

### **Difference Between Primary Market and Secondary Market**

| <b>Basis</b>               | <b>Primary Market</b>                                                                    | <b>Secondary Market</b>                                                                               |
|----------------------------|------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------|
| <b>Meaning</b>             | Market where new securities are issued for the first time by companies to raise capital. | Market where existing securities are traded among investors after being issued in the primary market. |
| <b>Also Called</b>         | New Issue Market (NIM).                                                                  | Stock Market or After Issue Market.                                                                   |
| <b>Purpose</b>             | Helps companies raise fresh funds for business expansion or new projects.                | Provides liquidity and continuous marketability to already issued securities.                         |
| <b>Participants</b>        | Issuing company and investors (direct relationship).                                     | Investors only (buying and selling among themselves).                                                 |
| <b>Price Determination</b> | Price is fixed by the issuing company (through prospectus, book building, etc.).         | Price is determined by demand and supply forces in the stock exchange.                                |
| <b>Instruments Traded</b>  | IPOs, FPOs, rights issues, private placements, etc.                                      | Equity shares, debentures, bonds, derivatives, etc.                                                   |
| <b>Regulator</b>           | SEBI regulates the issue process.                                                        | SEBI regulates trading through stock exchanges.                                                       |