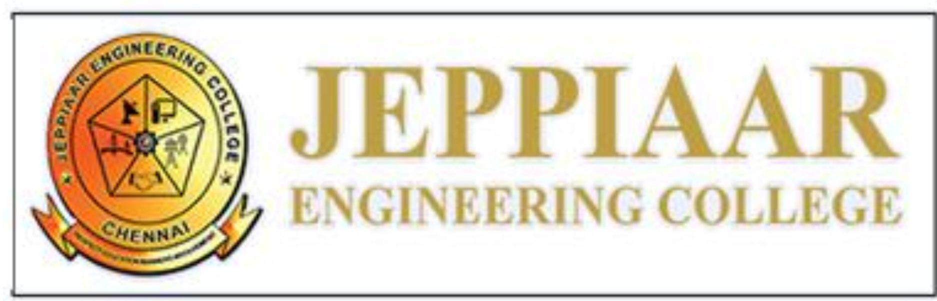

DEPARTMENT OF MANAGEMENT STUDIES

II YEAR / III SEMESTER

BA4002 : FINANCIAL MARKETS

Faculty In charge

Dr. E. Gopi

Anna University Chennai

Regulation 2021

JEPPIAAR ENGINEERING COLLEGE

DEPARTMENT OF MANAGEMENT STUDIES

VISION

To build Jeppiaar Engineering College as an institution of academic excellence in technology and management education, leading to become a world class university.

MISSION

- To excel in teaching and learning, research and innovation by promoting the principles of scientific analysis and creative thinking.
- To participate in the production, development and dissemination of knowledge and interact with national and international communities.
- To equip students with values, ethics and life skills needed to enrich their lives and enable them to contribute for the progress of society.
- To prepare students for higher studies and lifelong learning, enrich them with the practical skills necessary to excel as future professionals and entrepreneurs for the benefit of Nation's economy.

PROGRAMME EDUCATIONAL OBJECTIVES (PEOs):

MBA programme curriculum is designed to prepare the post graduate students

I. To have a thorough understanding of the core aspects of the business.

II. To provide the learners with the management tools to identify, analyze and create business opportunities as well as solve business problems.

III. To prepare them to have a holistic approach towards management functions.

IV. To inspire and make them practice ethical standards in business

PROGRAMME OUTCOMES (POs)

- Ability to apply the business acumen gained in practice.
- Ability to understand and solve managerial issues.
- Ability to communicate and negotiate effectively, to achieve organizational and individual goals.
- Ability to understand one's own ability to set achievable targets and complete them.
- Ability to fulfill social outreach
- Ability to take up challenging assignments

COURSE OBJECTIVE:

To understand the types and functions of the various financial markets in India, its instrumentsand Regulations

COURSE OUTCOME :

1. Understanding the basic concepts of the finance markets in India
2. Identify the underlying structure and functions of Indian financial markets
3. Familiarise the methods of issuing shares and the role of intermediaries in the primary market
4. Learn about the trading mechanism in stock market
5. Describe the instruments, participants and trading in debt market

CO -PO Matrix

Course Outcomes	Program Outcomes					
	PO1	PO2	PO3	PO4	PO5	PO6
CO1	3	3	1	0	0	1
CO2	3	3	2	0	0	1
CO3	3	3	1	0	0	1
CO4	3	3	1	0	0	1
CO5	3	3	2	0	0	1
Average	3	3	1.4	0	0	1

FINANCIAL MARKETS L T P C 3 0 0 3

UNIT I FINANCIAL MARKETS IN INDIA **9**

Indian financial system and markets – structure of financial markets in India –Types- Participants in financial Market – Regulatory Environment, - RBI, CCIL, Common securities market, Money market, - Capital market - Governments philosophy and financial market – financial instruments

UNIT II INDIAN CAPITAL MARKET- PRIMARY MARKET **9**

Primary Market - Primary market system - Types of scripts - Issue of capital: process, regulation pricing of issue, – Methods of floating new issues, Book building- Primary markets intermediaries: commercial banks, development banks, Merchant banker, issue managers, rating agencies etc – Role of primary market – Regulation of primary market.

UNIT III SECONDARY MARKET **9**

Stock exchanges in India - History and development -listing - Depositaries - Stock exchange mechanism: Trading, Settlement, risk management, Basics of pricing mechanism - Player and stock exchange - Regulations of stock exchanges –Role of SEBI – BSE, OTCEI, NSE, ISE, - Role of FIIs, MFs and investment bankers –Stock market indices – calculation.

UNIT IV DEBT MARKET AND FOREX MARKET **9**

Bond markets in India: Government bond market and its interface with capital market - Components of bond market - G-Sec, T-Bills, Corporate Bonds, Yield conventions, Role of primary dealers, Auction Markets - Pricing of Bonds

Introduction to Forex markets, basics in exchange rates theory - Forex risk exposures and basics of corporate forex risk management.

UNIT V MUTUAL FUNDS, DERIVATIVES MARKETS AND VENTURE CAPITAL AND PRIVATEEQUITY **9**

Mutual funds institutions in India. Types of mutual funds, Basics in portfolio management, Metrics of
performance for fund manager

Introduction to Derivatives and the size of derivatives markets -Brief introduction to forwards, Options,Futures And Swaps. Role of VCs and PEs in financial markets - Venture capital and Private equity

TOTAL: 45 PERIODS

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2. Pathak, Bharati V., Indian Financial System: Markets, Institutions and Services, Pearson education (Singapore), New Delhi, Fourth edition, 2014.
3. Saunders, Anthonu and Cornett, Marcia Millon, Financial markets and Institutions: An Introduction tothe risk management approach, McGrawHill, Irwin, New York,3rd Edition,2017.
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UNIT I FINANCIAL MARKETS IN INDIA

Indian financial system and markets – structure of financial markets in India –Types Participants in financial Market – Regulatory Environment, - RBI, CCIL, Common securities market, Money market, - Capital market - Governments philosophy and financial market –

PART – A

1. **Write short notes on Indian financial system.**

   A financial system may be defined as a **set of institutions, instruments and markets** which promotes savings and channels them to their most efficient use. It consists of individuals (savers), intermediaries, markets and users of savings (investors).

2. **What are the functions of financial system?**
   - Saving function
   - Liquidity function
   - Payment function
   - Risk function
   - Information function
   - Transfer function
   - Reformatory functions

3. **List the features of Indian Financial System.**
   - It plays a vital role in economic development of a country.
   - It encourages both savings and investment.
   - It links savers and investors.
   - It helps in capital formation.
   - It helps in allocation of risk.
   - It facilitates expansion of financial markets.

4. **List the components of Indian Financial System.**

   The following are the four major components that comprise the Indian Financial System:
   - Financial Institutions
   - Financial Markets
   - Financial Instruments/ Assets/ Securities
   - Financial Services.

5. **Define Financial Institutions.**

   Financial institutions are the **intermediaries who facilitate smooth functioning** of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return.

6. **What are the 3 types of Financial Institutions?**
   - Regulatory Institutions
   - Banking Institutions
   - Non - Banking Financial Institutions

7. **What do you mean by the term Regulatory Institutions?**

   It regulates the **business of exchanges**. It has complete access to the exchanges' financial records

and the companies listed on the exchange. It oversees the **listing and delisting process** of companies from any exchange in the country. It can take disciplinary action, including fines and penalties against malpractices.

8. List some Regulatory Bodies in India.

- Securities and Exchange Board of India (SEBI)
- Reserve Bank of India (RBI)
- Insurance Regulatory and Development Authority of India (IRDAI)
- Pension Funds Regulatory and Development Authority (PFRDA)

9. Define Banking Institutions (Reserve Bank of India).

Indian banking industry is subject to the control of the Central Bank. The RBI as the apex institution organizes **runs, supervises, regulates and develops the monetary system** and the financial system of the country. The main legislation governing commercial banks in India is the Banking Regulation Act, 1949.

10. List the types of Banking Institutions.

- Organized Sector
- Unorganized Sector.

11. List some Organized Sectors.

- Commercial banks,
- Cooperative banks
- Regional rural banks.

12. What is Commercial Bank?

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.

13. Define Co-operative bank.

Co-operative banks are financial entities established on a co-operative basis and belonging to their members. This means that the **customers of a co-operative bank are also its owners**. These banks provide a wide range of regular banking and financial services.

14. Explain Regional Rural Banks (RRBs).

Regional Rural Banks were set by the state government and sponsoring commercial banks with the **objective of developing the rural economy**. Regional rural banks provide banking services and credit to small farmers, small entrepreneurs in the rural areas.

15. What do you mean by Foreign Banks?

Foreign banks as **banks that have branches in the other countries** and main Head Quarter in the Home Country. With the deregulation (Elimination of Government Authority) in 1993, a number of foreign banks are entering India.

16. Who are all the Unorganized Sectors?

- Indigenous Bankers,
- Money Lenders.

17. Who is Indigenous Bankers?

Indigenous Bankers are private firms or **individual who operate as banks** and as such both receive deposits and given loans. Like bankers, they also financial intermediaries. They should be distinguished professional money lenders whose primary business is not banking and money lending.

18. Who is Money Lenders?

Money lenders **depend entirely to on their one fund**. Money Lenders may be rural or urban, professional or non-professional. They include large number of farmer, merchants, and traders. Their operations are entirely unregulated. They charge very high rate of interest.

19. Define Non - Banking Financial Institutions.

Nonbanking financial institution (NBFI) is a financial institution that **does not have a full banking license** and cannot accept deposits from the public.

20. List the Organized Non - Banking Financial Institutions.

- Development Finance Institutions.
- Investment Institutions.

21. What is Unorganized Non - Banking Financial Institutions.

The unorganized non - banking financial institutions include number of non - banking financial companies (NBFCs) **providing whole range of financial services**. These include hire - purchase 300 consumer finance companies, leasing companies, housing finance companies, factoring companies, Credit rating agencies, merchant banking companies etc. NBFCs mobilize public funds and provide loanable funds.

22. Define the term Financial Market.

Financial markets refer to the institutional arrangements for **dealing in financial assets and credit instruments** of different types such as currency, cheques, bank deposits, bills, bonds etc. These organized markets can be further classified into two they are

- Capital Market
- Money Market

23. What are the Functions of Financial Markets?

- To facilitate creation and allocation of credit and liquidity
- To serve as intermediaries for mobilization of savings.
- To assist the process of balanced economic growth.
- To provide financial convenience.

24. Define Capital Market

The capital market is a market for financial assets which **have a long or indefinite maturity**. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three namely:

- Industrial securities market
- Government securities market and
- Long term loans market

25. Define Industrial Securities Market.

It is a market where industrial concerns raise their capital or **debt by issuing appropriate instruments.** It can be further subdivided into two. They are:

- Primary market or new issue market
- Secondary market or Stock exchange

26. What is Primary Market?

Primary market is a market for **new issues or new financial claims**. Hence, it is also called New Issue market. The primary market deals with those securities which are issued to the public for the first time.

27. List the ways of raising capital in a primary market.

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

28. Define Secondary Market.

Secondary market is a market for **secondary sale of securities**. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted the Stock Exchange and it provides a continuous and regular market to buying and selling of securities.

29. What do you mean by Government Securities Market?

It is otherwise called **Gilt - Edged securities market**. It is a market where Government securities are traded. In India there are many kinds of Government Securities - short term and long term. Long term securities are traded in this market while short term securities are traded in the money market.

30. Define Long Term Loan Market.

Development banks and commercial banks play a significant role in this market by supplying **long term loans to corporate customers**. Term loans market

- Mortgages market
- Financial Guarantees market.

31. What is Term Loans Market?

A term loan is usually **meant for equipment, real estate, or working capital** paid off between one and 25 years. A small business often uses the cash from a term loan to purchase fixed assets, such as equipment or a new building for its production process.

32. Define Mortgages Market.

A mortgage loan is **a loan against the security of immovable property** like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage. This mortgage may be equitable mortgage or legal one.

33. Define Financial Guarantees Market.

A financial guarantee is a type of promise given by a **guarantor to take responsibility for the borrower in the case of default in payments to the lender or investor**. Generally, insurance companies give guarantee to back the debt of large corporations (the borrower) in payments to the market (the lender).

34. What is Money Market?

Money market is a market for dealing with **financial assets and securities which have a maturity period of up to one year.** In other words, it is a market for purely short term funds.

35. Explain Call Money Market.

The call money market is a market for **extremely short period loans** say one day to fourteen days. So, it is highly liquid. The loans are repayable on demand at the option of either the lender or the borrower.

36. What is Commercial Bills Market?

It is a market for **Bills of Exchange arising out of genuine trade transactions**. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill promising to pay at a later date specified in the bill.

The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

37. What is Treasury Bills Market?

It is a market for treasury bills which have ' short - term ' maturity. A treasury bill is a **promissory note or a finance bill issued by the Government**. It is highly liquid because its repayment is guaranteed by the Government.

38. List the types of Treasury Bills.

- **Ordinary or regular bills** are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short term financial needs.
- **Ad hoc treasury bills** are issued in favour of the RBI only. They are not sold through tender or auction.

39. Explain Short - Term Loan Market.

It is a market where short - term loans are given to corporate customers for **meeting their working capital requirements**. Commercial banks play a significant role in this market. Commercial banks provide short term loans in the form of cash credit and overdraft. Over draft facility is mainly given to business people whereas cash credit is given to industrialists.

40. Define Financial Instruments.

Financial instruments refer to those **documents which represents financial claims on assets.** Financial asset refers to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend.

Examples: Bill of exchange,
Promissory Note & Treasury Bill.

41. List the types of Financial Securities.

- **Primary Securities** These are securities directly issued by the ultimate investors to the ultimate savers. E.g. shares and debentures issued directly to the public.
- **Secondary Securities** These are securities issued by some intermediaries called financial intermediaries to the ultimate savers. E.g. Unit Trust of India and mutual funds issue securities in the form of units to the public and the money pooled is invested in companies.

42. Explain the types of Secondary Securities.

- **Short - term securities** are those which mature within a period of one year. E.g., Bill of exchange, Treasury bill, etc.
- **Medium term securities** are those which have a maturity period ranging between one and five years. E.g. Debentures maturing within a period of 5 years.
- **Long - term securities** are those which have a maturity period of more than five years. E.g., Government Bonds maturing after 10 years.

43. What is Financial Services?

Efficiency of emerging financial system largely depends upon the quality and variety of financial services provided by financial intermediaries.

The term financial services can be defined as "**activities, benefits, and satisfactions, connected with the sale of money**, which offer to users and customers, financial related value.

44. What are the different kinds of Financial Services?

- **Asset based/fund based services**
  - ✓ Equipment Leasing/ Lease Financing
  - ✓ Hire Purchase and Consumer Credit
  - ✓ Venture Capital
  - ✓ Insurance Services
  - ✓ Factoring
- **Fee based advisory services**
  - ✓ Merchant Banking
  - ✓ Credit Rating
  - ✓ Stock – Broking

45. Explain Equipment Leasing/ Lease Financing.

Leasing is an arrangement that provides a firm with the **use and control over assets without buying and owning the same**. It is a form of renting assets. However, in making an investment, the firm need not own the asset. It is basically interested in acquiring the use of the asset.

46. Explain the term Hire Purchasing.

Hire purchase means a **transaction where goods are purchased and sold on the terms** that (i) payment will be made in **installments**.

47. Define Consumer credit.

It includes all **asset based financing plans offered to individuals to help them acquire durable consumer goods**. In a consumer credit transaction, the individual/ consumer/ buyer pays a part of the cash purchase price at the time of the delivery of the asset and pays the balance with interest over a specified period of time.

48. Explain Venture Capital.

Venture capital (VC) is a form of **private equity and a type of financing that investors provide to startup companies and small businesses** that are believed to have long-term growth potential. Venture capital generally comes from well-off investors, investment banks, and any other financial institutions.

49. Define Insurance Services.

Insurance is a contract where by the **insurer's insurance company agrees/ undertakes, in consideration of a sum of money** (premium) to make good the loss suffered by the insured (policy holder) against a specified risk such as fire or compensate the beneficiaries (insured) on the happening of a specified event such as accident or death.

50. Explain Factoring.

Factoring is a type of finance in which a business would **sell its accounts receivable (invoices) to a third party to meet its short-term liquidity needs.** Under the transaction between both parties, the factor would pay the amount due on the invoices minus its commission or fees.

51. Define Merchant Banking.

Merchant banking is a professional service provided by the merchant banks to their customers **considering their financial needs**, for adequate consideration in the form of fee. Merchant banks are banks that conduct fundraising, financial advising and loan services to large corporations.

52. Explain Credit Rating.

Credit rating is the opinion of the **rating agency on the relative ability and willingness of the issuer of debt instrument** to meet the debt service obligations as and when they arise.

53. Define Stock-Broking.

Stock-broking is a service which gives retail and institutional **investors the opportunity to buy and sell equities.** Stockbrokers will trade shares both on exchange and over-the-counter, dependent on where they can find the best price and liquidity.

54. Who all are the participants in Financial Market?

- Insurance Companies
- Finance Companies
- Banks / Merchant Banks
- Companies/Firms
- The Individual
- Government
- Regulators

55. What do you mean by the term Regulatory Environment?

Regulations of financial institutions basically focus on **providing stability to the financial system, fair competition, consumer protection**, and the prevention and reduction of financial crimes.

56. Classify the components of Indian Financial System.

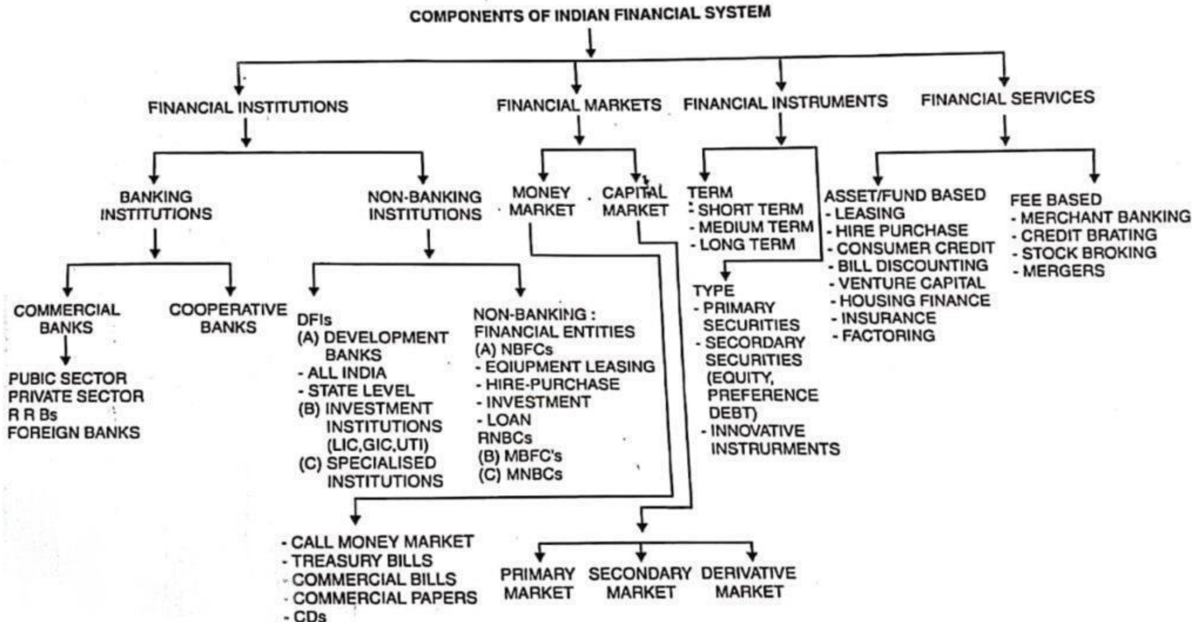


Figure 1.1: Components of Indian Financial System

57. What is RBI?

The Reserve Bank of India (RBI) is **India's central banking and monetary authority.** RBI regulates loans offered by banks and non-banking financial institutions to government entities, businesses, and consumers and controls the availability of funds in the financial system for credit.

58. List the major functions performed by the RBI.

- Note Issue
- Banker to the Government
- Banker's Bank
- Credit Control
- Custodian of Foreign Exchange Reserves
- Developmental Functions

59. What are the regulatory and promotional functions performed by RBI?

- Regulating the Volume of Currency
- Regulating Credit
- Control over Commercial Banks
- Determining the Monetary and Credit Policy
- Mobilizing Savings
- Institutional Credit to Agriculture
- Specialized Financial Institutions
- Security to Depositors
- Advisory Functions
- Policy Support

60. **What do you mean by CCIL?**

Clearing Corporation of India Ltd (CCIL): CCIL is a Central Counterparty (CCP) which was set up in April 2001 to provide clearing and settlement for transactions in Government securities, foreign exchange and money markets in the country.

61. **Define the term Common Securities Market.**

Common stock is a security that represents ownership in a corporation. Holders of common stock elect the board of directors and vote on corporate policies. This form of equity ownership typically yields higher rates of return long term. Stocks, bonds, preferred shares, and ETFs are among the most common examples of marketable securities.

62. **What is the Government role in financial market?**

A theoretical role for the government in the financial markets consists of: **regulation** (passive rules), **intervention** (active discretion), and their **personal financing needs**. Three of the most important regulatory rules for maintaining a stable economy are: a clear understanding of the fundamental role of the financial intermediary (saving, lending, and risk hedging), the use of interest rate caps, and implementation of an effective profit allocation scheme.

63. **List the characteristics of Financial Instruments.**
   - Liquidity
   - Marketing
   - Collateral value
   - Transferability
   - Maturity period
   - Transaction cost
   - Risk and Future trading

64. **List some Public Sector Banks.**
   - State Bank of India
   - Associate Bank
   - 14 Nationalized Banks (1969) Nationalized Banks
   - 6 Nationalized Banks (1980)
   - Regional Rural Banks Mainly sponsored by Public Sector Banks

65. **List some Private Sector Banks.**
   - New sophisticated Private Banks
   - Cooperative Banks included in the second schedule
   - Foreign banks in India, representative offices, and
   - One non-scheduled banks

PART – B

1. **Define Indian Financial System. Explain its various features, functions and importance of financial system in economic development.**

Meaning of Indian financial system:

   - The financial system enables lenders and borrowers to exchange funds. India has a financial system that is controlled by independent regulators in the sectors of insurance, banking, capital markets and various services sectors.
   - 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:

- In the worlds of Van Horne, “financial system allocates savings efficiently in an economy to ultimate users either for investment in real assets or for consumption”.
- According to Robinson, the primary function of the system is "to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth."

Concept of Indian financial system:

- The process of savings, finance and investment involves financial institutions, markets, instruments and services.
- Flow of Funds through Financial System can be understood with the help of the following Figure 1.2: Flow of Funds through Financial System.
- All supervision control and regulation are equally significant. Thus, financial management is an integral part of the financial system.

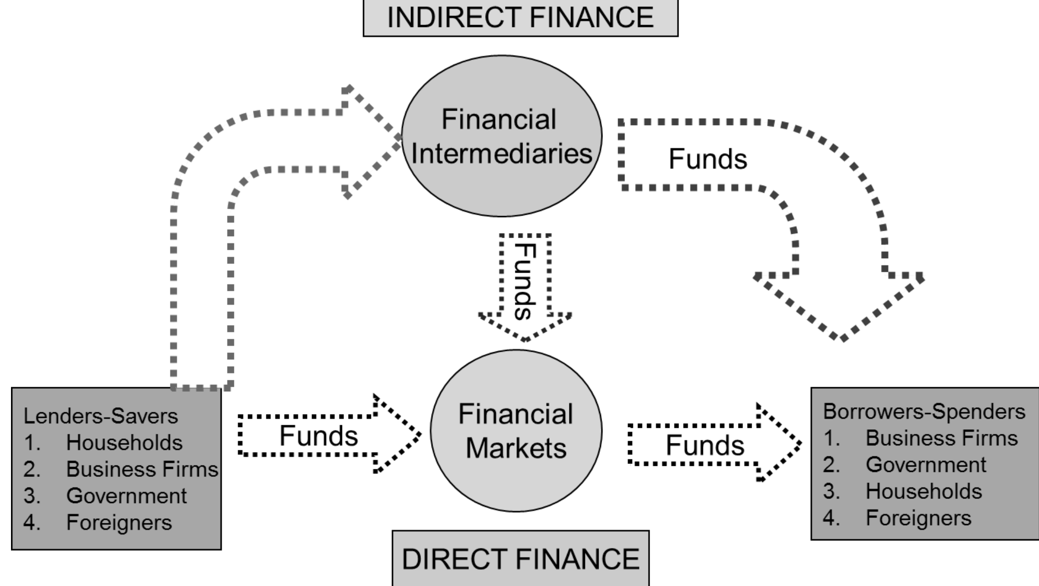


Figure 1.2: Flow of Funds through Financial System

Features of Indian financial system:

- It plays a vital role in economic development of a country.
- It encourages both savings and investment.
- It links savers and investors.
- It helps in capital formation.
- It helps in allocation of risk.
- It facilitates expansion of financial markets.

Functions of Indian financial system:

Saving function: An important function of a financial system is to mobilize savings and channelize them into productive activities.

Liquidity function: The most important function of a financial system is to provide money and monetary assets which can be converted into cash or money easily without loss of value.

Payment function: The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy.

Risk function: The financial markets provide protection against life, health and income risks.

Information function: A financial system makes available price-related information. This is a valuable help to those who need to take economic and financial decisions.

Transfer function: A financial system provides a mechanism for the transfer of the resources across geographic boundaries.

Reformatory functions: A financial system undertaking the functions of developing, introducing innovative financial assets/instruments services and practices and restructuring the existing assets, services etc.

Other functions: It assists in the selection of projects to be financed and also reviews performance of such projects periodically.

Importance of Indian financial system:

- It links the savers and investors. It helps in mobilizing and allocating the savings efficiently and effectively. It plays a crucial role in economic development through saving-investment process. This savings–investment process is called capital formation.
- It helps to monitor corporate performance.
- It provides a mechanism for managing uncertainty and controlling risk.
- It provides a mechanism for the transfer of resources across geographical boundaries.
- It offers portfolio adjustment facilities (provided by financial markets and financial intermediaries).
- It helps in lowering the transaction costs and increase returns. This will motivate people to save more.
- It promotes the process of capital formation.
- It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.
- In short, a financial system contributes to the acceleration of economic development. It contributes to growth through technical progress.

2. Briefly explain the components of Indian Financial Systems.

The Indian financial system can also be broadly classified into the formal (organised) financial system and the informal (unorganised) financial system. The formal financial system comes under the purview of the Ministry of Finance (MoF), the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), and other regulatory bodies. The informal financial system consists of:

- Individual moneylenders such as neighbors, relatives, landlords, traders, and store owners.
- Groups of persons operating as ‘funds’ or ‘associations.’ These groups function under a system of their own rules and use names such as ‘fixed fund,’ ‘association,’ and ‘saving club.’
- Partnership firms consisting of local brokers, pawnbrokers, and non-bank financial intermediaries such as finance, investment, and chit-fund companies.

Components of Indian Financial System:

1. Financial Institutions
2. Financial Instruments
3. Financial Services
4. Financial Markets

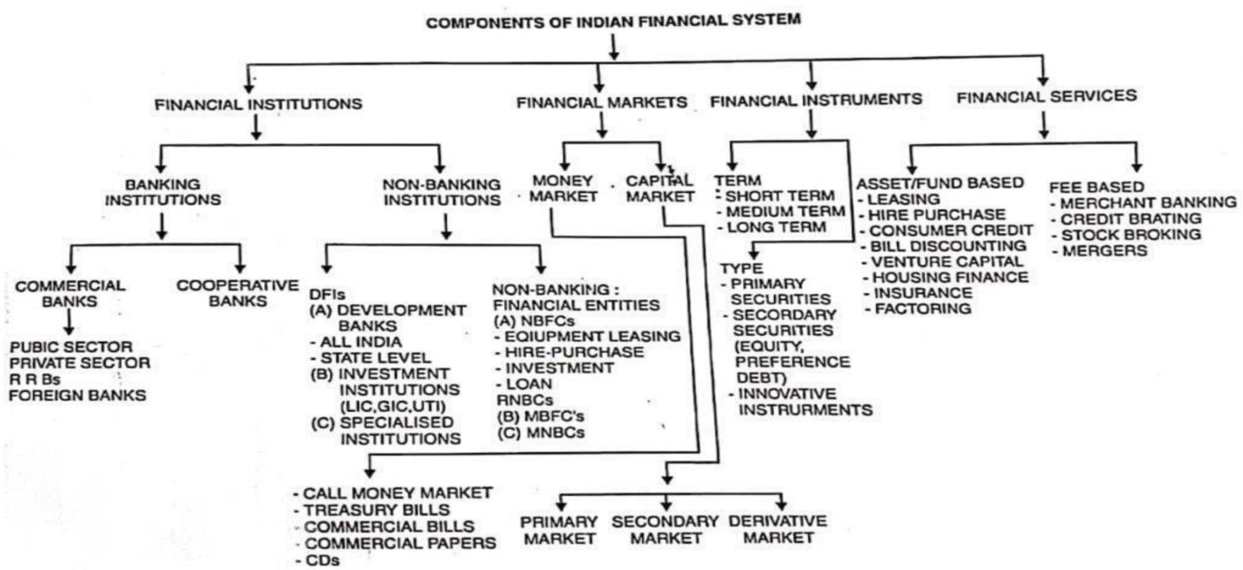


Figure 1.3: Components of Indian Financial System

1. Financial Institutions

The Financial Institutions act as a mediator between the investor and the borrower. The investor's savings are mobilised either directly or indirectly via the Financial Markets.

The main functions of the Financial Institutions are as follows:

- A short term liability can be converted into a long term investment
- It helps in conversion of a risky investment into a risk-free investment
- Also acts as a medium of convenience denomination, which means, it can match a small deposit with large loans and a large deposit with small loans

The best example of a Financial Institution is a Bank. The bank acts as an intermediate between the two. The financial institutions can further be divided into two types:

- **Banking Institutions or Depository Institutions –** This includes banks and other credit unions which collect money from the public against interest provided on the deposits made and lend that money to the ones in need
- **Non-Banking Institutions or Non-Depository Institutions –** Insurance, mutual funds and brokerage companies fall under this category. They cannot ask for monetary deposits but sell financial products to their customers.

Further, Financial Institutions can be classified into three categories:

- **Regulatory –** Institutes that regulate the financial markets like RBI, IRDA, SEBI, etc.
- **Intermediates –** Commercial banks which provide loans and other financial assistance such as SBI, BOB, PNB, etc.
- **Non Intermediates –** Institutions that provide financial aid to corporate customers. It includes NABARD, SIBDI, etc.

2. Financial Instruments

The products which are traded in the Financial Markets are called Financial Assets.

Some important Financial Assets have been discussed briefly below:

- **Call Money –** When a loan is granted for one day and is repaid on the second day, it is called call money. No collateral securities are required for this kind of transaction.
- **Notice Money –** When a loan is granted for more than a day and for less than 14 days, it is called notice money. No collateral securities are required for this kind of transaction.
- **Term Money –** When the maturity period of a deposit is beyond 14 days, it is called term money.

- **Treasury Bills –** Also known as T-Bills, these are Government bonds or debt securities with maturity of less than a year. Buying a T-Bill means lending money to the Government.
- **Certificate of Deposits –** It is a dematerialised form (Electronically generated) for funds deposited in the bank for a specific period of time.
- **Commercial Paper –** It is an unsecured short-term debt instrument issued by corporations.

3. Financial Services

Services provided by Asset Management and Liability Management Companies. They help to get the required funds and also make sure that they are efficiently invested.

- **Banking Services –** Any small or big service provided by banks like granting a loan, depositing money, issuing debit/credit cards, opening accounts, etc.
- **Insurance Services –** Services like issuing of insurance, selling policies, insurance undertaking and brokerages, etc. are all a part of the Insurance services
- **Investment Services –** It mostly includes asset management
- **Foreign Exchange Services –** Exchange of currency, foreign exchange, etc. are a part of the Foreign exchange services

4. Financial Markets

The marketplace where buyers and sellers interact with each other and participate in the trading of money, bonds, shares and other assets is called a financial market. The financial market can be further divided into four types:

- **Capital Market –** Designed to finance the long term investment, the Capital market deals with transactions which are taking place in the market for over a year. The capital market can further be divided into three types:

- Corporate Securities Market
- Government Securities Market
- Long Term Loan Market

- **Money Market –** Mostly dominated by Government, Banks and other Large Institutions, the type of market is authorized for small-term investments only. It is a wholesale debt market which works on low-risk and highly liquid instruments.
  The money market can further be divided into two types:

- Organised Money Market
- Unorganised Money Market

- **Foreign exchange Market –** One of the most developed markets across the world, the Foreign exchange market, deals with the requirements related to multi-currency. The transfer of funds in this market takes place based on the foreign currency rate.
- **Credit Market –** A market where short-term and long-term loans are granted to individuals or Organisations by various banks and Financial and Non-Financial Institutions is called Credit Market.

3. Briefly explain the Financial Institutions and its types.

FINANCIAL INSTITUTIONS

- Financial institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet.
- They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return.
- Financial institutions also provide services to entities (individual, business, government) seeking advice on various issue ranging from restructuring to diversification plans.

- They provide whole range of services to the entities who want to raise funds from the markets or elsewhere.
- Financial institutions are also termed as financial intermediaries because they act as middle between savers by accumulating Funds them and borrowers by lending these fund.
- It is also act as intermediaries because they accept deposits from a set of customers (savers lend these funds to another set of customers (borrowers).
- Like - wise investing institutions such ICCIC, mutual funds also accumulate savings and lend these to borrowers, thus perform the role of financial intermediaries.

TYPES OF FINANCIAL INSTITUTIONS

A. Banking Institutions

B. Non-Banking Financial Institutions

A. BANKING INSTITUTIONS (Reserve Bank of India)

- Indian banking industry is subject to the control of the Central Bank.
- The RBI as the apex institution organises, runs, supervises, regulates and develops the monetary system and the financial system of the country.
- The main legislation governing commercial banks in India is the Banking Regulation Act, 1949. The Indian banking institutions can be broadly classified into two categories:

1. Organised Sector
2. Unorganised Sector.

1. Organised Sector

The organized banking sector consists of commercial banks, cooperative banks and the regional rural banks.

(a) Commercial Banks:

- The commercial banks may be scheduled banks or non – scheduled banks.
- The commercial banks consist of 27 public sector banks, private sector banks and foreign banks. Prior to 1969, all major banks with the exception of State Bank of India in the private sector.

(b) Co-operative banks:

- An important segment of the organized sector of Indian banking is the co-operative banking.
- The segment is represented by agro up of societies registered under the Acts of the states relating to co-operative societies.

Different types of co-operative credit societies are operating in Indian economy. These institutions can be classified into two broad categories:

(a) Rural credit societies which are primary agriculture,

(b) Urban credit societies which are primarily non-agriculture.

For the purpose of agriculture credit there are different co-operative credit institutions to meet different kinds of needs.

(c) Regional Rural Banks (RRBs):

- Regional Rural Banks were set by the state government and sponsoring commercial banks with the objective of developing the rural economy.
- Regional rural banks provide banking services and credit to small farmers, small entrepreneurs in the rural areas.

(d) Foreign Banks:

- Foreign banks have been in India from British days. Foreign banks as banks that have branches in the other countries and main Head Quarter in the Home Country.

- With the deregulation (Elimination of Government Authority) in 1993, a number of foreign banks are entering India. Foreign Banks are: Citi Bank. Bank of Ceylon.

2. Unorganised Sector.

(a) Indigenous Bankers:

Indigenous Bankers are private firms or individual who operate as banks and as such both receive deposits and given loans.

(b) Money Lenders:

Money lenders depend entirely to on their one funds. Money Lenders may be rural or urban, professional or non-professional. They include large number of farmer, merchants, traders. Their operations are entirely unregulated. The charge very high rate of interest.

A. NON–BANKING INSTITUTIONS

The non – banking institutions may be categorized broadly into two groups:

(a) Organised Non–Banking Financial Institutions.

(b) Unorganised Non–Banking Financial Institutions.

(a) Organised Non– Banking Financial Institutions The organized non-banking financial institutions include:

1. **Development Finance Institutions**.

These include: The institutions like IDBT, ICICI, IFCI, IIBI, IRDC at all India level.

- The State Finance Corporations (SFCs), State Industrial Development Corporations (SIDCs) at the state level.
- Agriculture Development Finance Institutions as NABARD, LDBS etc. Development banks provide medium and long term finance to the corporate and industrial sector and also take up promotional activities for economic development

2. **Investment Institutions.**

- These include those financial institutions which mobilise savings at the public at large through various schemes and invest these funds in corporate and government securities.
- These include LIC, GIC, LTT, and mutual funds.
- The non - banking financial institutions in the organised sector have been discussed at length in detail in separate chapters of this book.

(b) Unorganised Non - Banking Financial Institutions

- The unorganised non - banking financial institutions include number of non –banking financial companies (NBFCs) providing whole range of financial services.

4. Briefly explain the Financial Instruments and its types.

- Financial instruments are the financial assets, securities and claims. They may be viewed as financial assets and financial liabilities.
- Financial assets represent claims for the payment of a sum of money sometime in the future (repayment of principal) and / or a periodic payment in the form of interest or dividend.
- Financial liabilities are the counterparts of financial assets - They represent promise to pay some portion of prospective income and wealth to others. Financial assets and liabilities arise from the basic process of financing. Some of the financial instruments are tradable / transferable. Others are non-tradable / non-transferable.
- Financial assets like deposits with banks, companies and post offices, insurance policies, NSCs, provident funds and pension funds are not tradable. Securities (included in financial assets) like equity shares and debentures, or government securities and bonds are tradable. Hence they are transferable. In short, financial instruments are instruments through which a company raises

finance.

- The financial instruments may be capital market instruments or money market instruments or hybrid instruments. The financial instruments that are used for raising capital through the capital market are known as capital market instruments. These include equity shares, preference shares, warrants, debentures and bonds. These securities have a maturity period of more than one year.
- The financial instruments that are used for raising and supplying money in a short period not exceeding one year through money market are called money market instruments. Examples are treasury bills, commercial paper, call money, short notice money, certificates of deposits, commercial bills, money market mutual funds.
- Hybrid instruments are those instruments which have both the features of equity and debenture. Examples are convertible debentures, warrants etc.
- Financial instruments may also be classified as cash instruments and derivative instruments. Cash instruments are financial instruments whose value is determined directly by markets.
- Derivative instruments are financial instruments which derive their value from some other financial instrument or variable.
- Financial instruments can also be classified into primary instruments and secondary instruments. Primary instruments are instruments that are directly issued by the ultimate investors to the ultimate savers.

Characteristics of Financial Instruments

The important characteristics of financial instruments may be outlined as below:

- **Liquidity:** Financial instruments provide liquidity. These can be easily and quickly converted into cash.
- **Marketing:** Financial instruments facilitate easy trading on the market. They have a ready market.
- **Collateral value:** Financial instruments can be pledged forgetting loans.
- **Transferability:** Financial instruments can be easily transferred from person to person.
- **Maturity period:** The maturity period of financial instruments may be short term, medium term or long term.
- **Transaction cost:** Financial instruments involve buying and selling cost. The buying and selling costs are called transaction costs. These are lower.
- **Risk:** Financial instruments carry risk. This is because there is uncertainty with regard to payment of principal or interest or dividend as the case may be.
- **Future trading:** Financial instruments facilitate future trading so as to cover risks due to price fluctuations, interest rate fluctuations etc.

Types of Financial Instruments:

Financial instruments may be divided into three broad categories: equity (including hybrid instruments), debt and derivatives. These three categories reflect the nature and main characteristics of financial instruments.

EQUITY:

- The principal form of equity issued by a corporation is an ordinary share or common stock.
- Ordinary shares have no maturity date; they continue for the life of the corporation. However, as the shares are listed on the stock exchange, they may be sold to other investors at the current market price.
- An ordinary shareholder is entitled to share in the profits of the business. Shareholders generally receive a portion of the profits of the company in the form of dividend payments. The value of a corporation's shares may increase over time, representing a capital gain.

- Another form of equity is known as a hybrid security. A hybrid security may be described as having the characteristics of both equity and debt.
- Preference shares are an example of hybrid securities. Preference shares, while being a form of equity finance, have many characteristics in common with debt instruments. The fixed dividend must be paid before any dividend is made to ordinary shareholders.
- Preference shareholders also rank ahead of ordinary shareholders in their claim on the assets of the corporation should the company be wound up or placed into liquidation.

DEBT

- A debt is a loan that must be repaid. Debt instruments represent a contractual claim against an issuer, and require the borrower to make specified payments, such as periodic interest payments and principal repayments, over a defined period.
- The types of debt instruments issued by a corporation include debentures, unsecured notes, term loans, commercial bills, promissory notes, overdrafts and mortgage loans.
- Debentures and unsecured notes are longer-term debt instruments issued into the capital markets, while commercial bills and promissory notes are short-term instruments issued into the money markets.
- Term loans, mortgage loans and overdrafts are generally provided by financial institutions. Government debt instruments are Treasury bonds and Treasury notes (T-notes); Debt instruments entitle the holder to a claim (ahead of equity holders) to the income stream produced by the borrower and to the assets of the borrower if the borrower defaults on loan repayments.
- Debt can be divided into two subcategories on the basis of the nature of the loan contract: secured debt and unsecured debt.
- A secured debt contract will specify the assets of the borrower, or a third party, pledged as security or collateral. If the borrower defaults on the loan, the lender is entitled to take possession of those assets to recover the amount owing.
- In other cases, a loan may be made on an unsecured basis. Another subdivision of debt is based on the transferability of ownership of the instrument. Negotiable debt instruments are those that can easily be sold and transferred from one owner to another.
- Commercial bills are an example of negotiable debt instruments that can be sold in the money markets.
- Non-negotiable instruments are instruments that cannot be transferred from one party to another.
- A term loan obtained through a bank is generally non-negotiable.

DERIVATIVES

- Derivative contracts are primarily used to manage an exposure to an identified risk. For example, a borrower might be concerned that interest rates on existing debt funding may rise in the future.
- The borrower can accept this forecast risk, or seek to reduce that risk exposure by locking in an interest rate today. One way the borrower can lock in an interest rate is through the use of derivative contracts.
- There is a wide range of derivative contracts for the management of risk exposure related to commodities (such as gold and oil) and financial instruments (such as interest-rate-sensitive debt, currencies and equities). Therefore, financial derivatives may be used to manage risk exposures related to both equity and debt.
- There are four basic types of derivative contracts: futures, forwards, options and swaps:

- ✓ A futures contract is a contract to buy (or sell) a specified amount of a commodity or financial instrument at a price determined today for delivery or payment at a future date.
- ✓ A forward contract is similar to a futures contract but is typically more flexible and is negotiated over the counter with a commercial bank or investment bank. A forward foreign exchange contract establishes a foreign currency exchange rate that will apply at a specified date.
- ✓ An option contract gives the buyer of the option the right—but not an obligation—to buy (or sell) the designated asset at a specified date or within a specified period during the life of the contract, at a predetermined price.
- ✓ A swap contract is an arrangement to exchange specified future cash flows. With an interest rate swap there is an exchange (swap) of future interest payments based on a notional principal amount.

5. Briefly explain the Financial Markets and its functions.

It is through financial markets and institutions that the financial system of an economic works. Financial markets refer to the institutional arrangements for dealing in financial assets and credit instruments of different types such as

- ➢ currency,
- ➢ cheques,
- ➢ bank deposits,
- ➢ bills,
- ➢ bonds etc.

Functions of financial markets are:

- ➢ To facilitate creation and allocation of credit and liquidity
- ➢ To serve as intermediaries for mobilisaton of savings.
- ➢ To assist the process of balanced economic growth.
- ➢ To provide financial convenience.
- ➢ To cater to the various credit needs of the business houses.

These organised markets can be further classified into two they are

(i)Capital Market

(ii) Money Market

CAPITAL MARKET

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three namely:

1. Industrial securities market
2. Government securities market and
3. Long term loans market

I. INDUSTRIAL SECURITIES MARKET: As the very name implies, it is a market for industrial securities namely:

- ➢ Equity shares or ordinary shares,
- ➢ Preference shares and
- ➢ Debentures or bonds.

It is a market where industrial concerns raise their capital or debt by issuingappropriate instruments. It can be further subdivided into two. They are:

1. Primary market or New issue market

2. Secondary market or Stock exchange

1. Primary Market

- Primary market is a market for new issues or new financial claims. Hence, it is also called New Issue market.
- The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long term funds.
- Thus, primary market facilitates capital formation.
- There are three ways by which a company may raise capital in a primary market. They are:
    - ✓ Public issue
    - ✓ Rights issue
    - ✓ Private placement

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

2. Secondary Market

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

II. GOVERNMENT SECURITIES MARKET:

- It is otherwise called Gilt - Edged securities market. It is a market where Government securities are traded.
- In India there are many kinds of Government Securities - short term and long term. Long term securities are traded in this market while short term securities are traded in the money market.
- Securities issued by the Central Government, State Governments, Semi Government authorities like City Corporations, Port Trusts etc.
- Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in this market.

III. LONG TERM LOANS MARKET: Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers.

Long term loans market may further be classified into:

- Term loans market
- Mortgages market
- Financial Guarantees market.

Term Loans Market

In India, many industrial financing institutions have been created by the Government both at the national and regional levels to supply long term and medium term loans to corporate customers directly as well as indirectly.

Mortgages Market

A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage. This mortgage may be equitable mortgage or legalone.

MONEY MARKET

Money market is a market for dealing with financial assets and securities which have a maturity period of up to one year. In other words, it is a market for purely short term funds. The money market may be subdivided into four. They are:

- Call money market
- Commercial bills market
- Treasury bills market
- Short term loan market.

Call Money Market

The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on demandat the option of either the lender or the borrower.

Commercial Bills Market

It is a market for Bills of Exchange arising out of genuine trade transactions. Inthe case of credit sale, the seller may draw a bill of exchange on the buyer. Thebuyer accepts such a bill promising to pay at a later date specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

Treasury Bills Market

It is a market for treasury bills which have ' short - term ' maturity. A treasury bill is a promissory note or a finance bill issued by the Government. It is highly liquid because its repayment is guaranteed by the Government. It isan important instrument for short term borrowing of the Government There are two types of treasury bills namely

(i) ordinary or regular and

(ii) ad hoc treasury bills popularly known as ' ad hocs'.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short term financial needs. Ad hoc treasury bills are issued in favour of the RBI only. They are not sold through tender or auction. They can be purchased by the RBI only.

Ad hocs are not marketable in India but holders of these bills can sell them back to RBI.

Short - Term Loan Market

It is a market where short - term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play asignificant role in this market. Commercial banks provide short term loans in the form of cash credit and overdraft Over draft facility is mainly given to business people whereas cash credit is given to industrialists.

6. Briefly explain the Functions of Capital and Money Market.

- **Economic development:** The money market provides short term funds to both public and private institutions. These institutions need money to finance their capital needs.
- **Profitable investment:** The commercial banks deal with the deposits of their customers. The banks are required to put their assets into cash form to meet the directions of the central bank.
- **Borrowings by the government:** The money market helps the government in borrowing short term funds at very low interest rates. The borrowing is done on the basis of treasury bills.

- **Importance for central bank:** If the money market is well - developed, the central bank implements the monetary policy successfully. It is only through the money market that the central bank can control the banking system and thus contribute to the development of trade and commerce.
- **Mobilisation of funds:** The money market helps in transferring funds from one sector to another. The development of any economy depends on availability of finance. No country can develop its trade, commerce and industry until and unless the financial resources are mobilized.
- **Savings and investment:** The money market is that it helps in promoting liquidity and safety of financial assets. By doing so it can help in encouraging savings and investment. The saving and investment equilibrium of demand and supply of loanable funds helps the allocation of resources.

FUNCTIONS OF CAPITAL MARKET

- **Helps in capital formation:** The capital market plays an important role in mobilisation of savings and channel them into productive investments for the development of commerceand industry. As such, the capital market helps in capital formation and economic growth of the country.
- **Act as link between savers and investors:** The capital market acts as an important link between savers and investors. The savers are lenders of funds while investors are borrowers of funds. The savers who do not spend all their income are called "Surplus units" and the borrowers are known as " deficit units.
- **Helps in increasing national income:** Funds come into the capital market from individuals and financial intermediaries and are used by commerce, industry and government. It thus facilitates the transfer of funds to be used more productively and profitabilityto increases the national income.
- **Facilitates buying and selling:** Surplus units buy securities with their surplus funds and deficit wits ells securities to raise the funds they need. Funds flow from lenders to borrowerseither directly or indirectly through financial institutions such as banks, unit trusts, mutual funds, etc.
- **Channelizes funds from unproductive to productive resources:** The capital market provides a market mechanism for those who have savingsand to those who need funds for productive investments.
- **Minimizes speculative activities:** It does so by providing capital to the needy al reasonable interest rates andhelps in minimising speculative activities.
- **Brings stability in value of stocks**: A well - developed capital market comprising expert banking and non - banking intermediaries brings stability in the value of stocks and securities.
- **Promotes economic growth:** The capital market encourages economic growth. The various institutions which operate in the capital market give quantities and qualitative direction to the flow of funds and bring rational allocation of resources. They do so by converting financial assets into productive physical assets.

7. Briefly explain the Features and Functions of Primary and Secondary Market.

FEATURES OF PRIMARY MARKETS:

- This is the market for new long term equity capital. The primary market is the market where the securities are sold for the first time. Therefore, it is also called the new issue market (NIM).
- In a primary issue, the securities are issued by the company directly to investors.
- The company receives the money and issues new security certificates to the investors
- Primary issues are used by companies for the purpose of setting up new business or for expanding or modernizing the existing business.
- The primary market performs the crucial function of facilitating capital formation in the economy.

- The new issue market does not include certain other sources of new long term external finance, such as loans from financial institutions. Borrowers in the new issue market may be raising capital for converting private capital into public capital,this is known as " going public. "

FUNCTIONS OF NEW ISSUE MARKET

The main functions of a new issue sue market can have divided into new project.

1. Origination.

It refers to the work of investigation analysis and processing of new project proposals. It starts before an issue is actually floated in the market.

2. Underwriting.

It is an agreement whereby the underwriter promises to subscribe to specified number of shares or debentures or a specified amount of stock in theevent of public not subscribing to the issue. If the issue is fully subscribed, then there is no liability for the underwriter. If a part of share issues remains unsold, the underwriter will buy the shares.

3. Distribution.

It is the function of sale of securities to ultimate investors. This service is performed by specialized agencies like brokers and agents who maintain a regular direct contact with the ultimate investors.

SECONDARY MARKET

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

FUNCTIONS OF STOCK EXCHANGE

The stock exchanges play an important role in the economic development of acountry.

Ensure Liquidity of Capital.

The stock exchanges where buyers and sellers are converted into cash.

Continuous Market for Securities.

The stock exchanges provide a ready market in securities. The securities oncelisted continue to be traded at the exchanges irrespective the fact that ownersgo on changing.

Mobilising Surplus Savings.

The stock exchanges provide a ready market for various securities. The investors do not have any difficulty in investing their savings by purchasing shares, bonds etc, from the exchanges.

Helpful in Raising New Capital.

The new and existing concerns need capital for their activities. The new concerns raise capital for the first time and existing units increase their capitalfor expansion and diversification purposes.

Safety in Dealings:

The dealings at stock exchanges are governed by well - defined rules and regulations of Securities Contract (Regulation) Act, 1956. There is no scope manipulating transactions.

Listing of Securities.

Only listed securities can be purchased at stock exchanges. Every company desirous of listing its securities will apply to the exchange authorities. The listing is allowed only after a critical

examination of capital structure, management and prospects of the company.

Smoothens the Price Movements.

A stock exchange smoothens the price movements of stocks in the market by ensuring a continuous flow of securities.

Investor Protection.

The stock exchange renders safeguarding activities for investors in securities. It provides a grievance redressal mechanism for investors. Stock exchanges also operate a compensation fund for the protection of investors.

8. Briefly explain the Financial Services in India.

The term financial services can be defined as "activities, benefits, and satisfactions, connected with the sale of money, that offer to users and customers, financial related value. within the financial services industry, the main sectors are banks, financial institutions, and non-banking financial companies.

Financial Services

- The development of a sophisticated and matured financial system in the country, especially after the early nineties, led to the emergence of a new sector.
- This new sector is known as financial services sector. Its objective is to intermediate and facilitate financial transactions of individuals and institutional investors.
- The financial institutions and financial markets help the financial system through financial instruments. Important financial services include lease financing, hire purchase, instalment payment systems, merchant banking, factoring, forfaiting etc.

The Banking System

- The structure of the banking system is determined by two basic factors – economic and legal. The Development of the economy and the spread of banking habit calls for increasing banking services.
- The demand for these banking services affects the banks' structure and organization. National objectives and aspirations resulting government regulations, which have a profound influence on‟ the banking structure.
- These regulations are basically of two types. First, regulations which result in the formation of new banks to meet the specific needs of a group of economic activities.
- Secondly, legislation that affects the structure by means of nationalization, mergers or liquidation.

Reserve Bank of India

- The Reserve Bank of India as the central bank of the country, is at the head of this group.
- Commercial banks themselves may be divided into two groups, the scheduled and the non-scheduled banks. The commercial banking system may be distinguished into:

A. Public Sector Banks

i) State Bank of India
ii) Associate Bank
iii) 14 Nationalized Banks (1969) Nationalized Banks
iv) 6 Nationalized Banks (1980)
v) Regional Rural Banks Mainly sponsored by Public Sector Banks

B. Private Sector Banks

i) Other Private Banks;
ii) New sophisticated Private Banks;

iii) Cooperative Banks included in the second schedule;
iv) Foreign banks in India, representative offices, and
v) One non-scheduled banks

Cooperative Sector

- The cooperative banking sector has been developed in the country to supplant the village money lender, the predominant source of rural finance, as the terms on which he made finance available have generally been usurious and detrimental to the development of Indian agriculture.
- Although the sector receives concessional finance from the Reserve Bank, it is governed by the state legislation.
- From the point of view of the money market, it may be said to lie between the organized and the unorganized markets.

Primary cooperative Credit Societies

- The primary cooperative credit society is an association of borrowers and non-borrowers residing in a particular locality.
- The funds of the society are derived from the share capital and deposits of members and loans from Central Co-operative banks.
- The borrowing power of the members as well as of the society is fixed. The loans are given to members for the purchase of cattle, fodder, fertilizers, pesticides, implements etc.

Central Co-operative Banks

- These are the federations of primary credit societies in a district. These banks finance member societies within the limits of the borrowing capacity of societies.
- They also conduct all the business of a joint-stock bank.

State Co-operative Banks

- The State Cooperative Bank is a federation of Central cooperative banks and acts as a watchdog of the cooperative banking structure in the State.
- Its funds are obtained from share capital, deposits, loans and overdrafts from the Reserve Bank of India.
- The State Co-operative Banks lend money to central cooperative banks and primary societies and not directly to farmers.

Land Development Banks

The Land Development Banks, which are organized in three tiers, namely, State, Central and Primary level, meet the long-term credit requirements of farmers for developmental purposes, viz, purchase of equipment like pump sets, tractors and other machineries, reclamation of land, fencing, digging up new wells and repairs of old wells etc.

KINDS OF FINANCIAL SERVICES

Financial services provided by various financial institutions, commercial banks and merchant bankers can be broadly classified into two categories.

1. Asset based/fund based services.
2. Fee based/advisory services.

Asset based/fund based services

The asset/ fund based services provided by banking and non - banking financial institutions as discussed below briefly.

- **Equipment Leasing/ Lease Financing**
    - ✓ Leasing is an arrangement that provides a firm with the use and control over assets without

buying and owning the same. It is a form of renting assets.

- ✓ However, in making an investment, the firm need not own the asset. It is basically interested in acquiring the use of the asset.

- **Hire Purchase and Consumer Credit**

Hire purchase means a transaction where goods are purchased and sold on the terms that

(i) payment will be made in installments,

(ii) the possession of the goods is given to the buyer immediately,

(iii) the property ownership in the goods remains with the vendor till the last installment is paid,

(iv) the seller can repossess the goods in case of default in payment of any instalment, and

(v) each instalment is treated as hire charges till the last instalment is paid.

- **Consumer credit**
  - ✓ Includes all asset based financing plans offered to individuals to help them acquire durable consumer goods.
  - ✓ In a consumer credit transaction, the individual/ consumer/ buyer pays a part of the cash purchase price at the time of the delivery of the asset and pays the balance with interest over a specified period of time.

- **VENTURE CAPITAL**
  - ✓ In the real sense, venture capital financing is one of the most recent entrantsin the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked.
  - ✓ These **venture capital** companies provide the necessary risk capital to the entrepreneurs so as to meet the promoter's contribution as required by the financial institutions.
  - ✓ In addition to providing capital, these VCFS (venture capital firms) take an activeinterest in guiding the assisted firms.

- **Insurance Services**
  - ✓ Insurance is a contract where by the insurer e. insurance company agrees/ undertakes, in consideration of a sum of money (premium) to make good the loss suffered by the insured (policy holder) against a specified risk such as fireor compensate the beneficiaries (insured) on the happening of a specified event such as accident or death.
  - ✓ The document containing the terms of contract, in black and white, between the insurer and the insured is called policy.
  - ✓ The property which is insured is the subject matter of insurance.
  - ✓ The interest which the insured has in the subject matter of insurance is known as insurable interest.
  - ✓ Depending upon the subject matter, insurance services are divided into (i) life (ii) general.

- **Factoring**

Factoring, as a fund based financial service provides resources to finance receivables as well as it facilitates the collection of receivables. It is another method of raising short - term finance through account receivable credit offered by commercial banks and factors.

FEE BASED ADVISORY SERVICES

- **Merchant Banking**

Fee based advisory services includes all these financial services rendered by Merchant Bankers. Merchant bankers play an important role in the financial services Sector. The Industrial Credit and Investment Corporation of India (ICICI) was the first development finance institution to initiate such service in 1974. After mid - seventies, tremendous growth in the number of

merchant banking organisations les taken place.

➢ **Credit Rating**

Credit rating is the opinion of the rating agency on the relative ability and willingness of the issuer of debt instrument to meet the debt service obligations as and when they arise. As a fee based financial advisory service, credit rating useful to investors, corporates (borrowers), banks and financial institutions.

➢ **Stock - Broking**

The need to reform stock exchanges was felt, when malpractices crept into Trading and in order to protect investor's interests, SEBI was set up to ensure that stock exchange perform their self - regulatory role properly.

9. Explain the Structure of Indian Financial Market, it's types and Participants.

A financial market is a broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives. Based on nature, maturity, timing and structure, the financial market is divided into various categories as shown in the figure 1.5.

Figure 1.4: Functions of Indian Financial Market

Figure 1.5: Structure of Indian Financial Market

1. By Nature of Claim

➢ **Debt Market:** The market where fixed claims or debt instruments, such as debentures or bonds are bought and sold between investors.

➢ **Equity Market:** Equity market is a market wherein the investors deal in equity instruments. It is the market for residual claims.

2. By Maturity of Claim

- **Money Market:** The market where monetary assets such as commercial paper, certificate of deposits, treasury bills, etc. which mature within a year, are traded is called money market.
- **Capital Market:** The market where medium and long term financial assets are traded in the capital market. It is divided into two types:

1. **Primary Market:** A financial market, wherein the company listed on an exchange, for the first time, issues new security or already listed company brings the fresh issue.
2. **Secondary Market:** Alternately known as the Stock market, a secondary market is an organised marketplace, wherein already issued securities are traded between investors, such as individuals, merchant bankers, stockbrokers and mutual funds.

3. By Timing of Delivery

- **Cash Market:** The market where the transaction between buyers and sellers are settled in real-time.
- **Futures Market:** Futures market is one where the delivery or settlement of commodities takes place at a future specified date.

4. By Organizational Structure

- **Exchange-Traded Market:** A financial market, which has a centralised organisation with the standardised procedure.
- **Over-the-Counter Market**: An OTC is characterised by a decentralised organisation, having customised procedures.

10. Explain the Regulatory Institutions in India.

Regulations of financial institutions basically focus on providing stability to the financial system, fair competition, consumer protection, and the prevention and reduction of financial crimes.

- **Reserve Bank of India:** The Reserve Bank of India was established in 1935 under the provisions of the Reserve Bank of India Act, 1934 in Calcutta, eventually moved permanently to Mumbai. Though originally privately owned, was nationalized in 1949.

Organisation and Management: The Reserve Bank's affairs are governed by a central board of directors. The board is appointed by the Government of India for a period of four years, under the Reserve Bank of India Act.

Full-time officials: Governor and not more than four Deputy Governors. The current Governor of RBI is Mr. Urjit Pattel. There are 3 Deputy Governors presently – B P Kanungo, N S Vishwanathan and Viral V Acharya.

Nominated by Government: ten Directors from various fields and two government Officials

Others: four Directors – one each from four local boards.

Let us make in-depth study of the functions and promotional roles of Reserve Bank of India (RBI).

Functions: The Reserve Bank of India is performing various functions related to monetary management, banking operations, foreign exchange, developmental works and research on problems of economy, as shown in figure 1.4.

The following are some of the major functions normally performed by the Reserve Bank of India:

- **Note Issue:** Being the Central Bank of the country, the RBI is entrusted with the sole authority to issue currency notes after keeping certain minimum reserve consisting of gold reserve worth Rs. 115 crore and foreign exchange worth Rs. 85 crores. This provision was later amended and simplified.
- **Banker to the Government:** The RBI is working as banker of the government and therefore all funds of both Central and State Governments are kept with it. It acts as an agent of the

government and manages its public debt. RBI also offering “ways and means advance” to the government for short periods.

- **Banker’s Bank:** The RBI is also working as the banker of other banks working in the country. It regulates the whole banking system of the country, keep certain percentage of their deposits as minimum reserve, works as the lender of the last resort to its scheduled banks and operates clearing houses for all other banks.
- **Credit Control:** The RBI is entrusted with the sole authority to control credit created by the commercial banks by applying both quantitative and qualitative credit control measures like variation in bank rate, open market operation, selective credit controls etc.
- **Custodian of Foreign Exchange Reserves:** The RBI is entrusted with sole authority to determine the exchange rate between rupee and other foreign currencies and also to maintain the reserve of foreign exchange earned by the Government. The RBI also maintains its relation with International Monetary Fund (IMF).
- **Developmental Functions:** The RBI is also working as a development agency by developing various sister organisations like Agricultural Refinance Development Corporation. Industrial Development Bank of India etc. for rendering agricultural credit and industrial credit in the country.

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

- Under these circumstances, the government felt the need for setting up of an apex body to develop and regulate the stock market in India Eventually, the Securities and Exchange Board of India (SEBI) Was set on April 12, 1998. To start with, SEBI was set up as a non - statutory body.
- It took almost four years for the government to bring about a separate legislation in the name of Securities and Exchange Board of India Act 1992 conferring statutory powers. The Act, charged to SEBI with comprehensive powers over practically all aspects of capital market operations.

Objectives of SEBI

According to the preamble of the SEBI Act, the primary objective of the SEBI is to promote healthy and orderly growth of the securities market and secure investor protection. For this purpose, the SEBI monitor the activities of not only stock exchanges but also merchant bankers etc. The objectives of SEBI are as follows:

- To protect the interest of investors so that there is a steady flow of savings into the capital market.
- To regulate the securities market and ensure fair practices by the issuers of securities so that they can raise resources at minimum cost.
- To promote efficient services by brokers, merchant bankers and other intermediaries so that they become competitive and professional.

11. Explain the Functions of RBI and SEBI.

The following are some of the regulatory and promotional functions performed by the RBI:

1. **Regulating the Volume of Currency:** The RBI is performing the regulatory role in issuing and controlling the entire volume of currency in the country through its Issue Department. While regulating the volume of currency the RBI is giving priority on the demand for currency and the stability of the economy equally.
2. **Regulating Credit:** The RBI is also performing the role to control the credit money created by the commercial banks through its qualitative and quantitative methods of credit control and thereby maintains a balance in the money supply of the country.
3. **Control over Commercial Banks:** Another regulatory role performed by the RBI is to have control over the functioning of the commercial banks. It also enforces certain prudential norms and

rational banking principles to be followed by the commercial banks.

4. **Determining the Monetary and Credit Policy:** The RBI has been formulating the monetary and credit policy of the country every year and thereby it controls the Statutory Liquidity Ratio (SLR), Cash Reserve Ratio (CRR), bank rate, interest rate, credit to priority sectors etc.
5. **Mobilizing Savings:** The RBI is playing a vital promotional role to mobilize savings through its member commercial banks and other financial institutions. RBI is also guidingthe commercial banks to extend their banking network in the unbanked rural and semi-urban areas and also to develop banking habits among the people.
6. **Institutional Credit to Agriculture:** The RBI has been trying to increase the flow of institutional credit to agriculture from the very beginning. Keeping this objective in mind, the RBIset up ARDC in 1963 for meeting the long term credit requirement of rural areas. Later on in July 1982, the RBI set up NABARD and merged ARDC with it to look after its agricultural credit functions.
7. **Specialized Financial Institutions:** The RBI has also been playing an important promotional role for setting specialized financial institutions for meeting the long term credit needs of large and small scale industries and other sectors. Accordingly, the RBI has promoted the development of various financial institutions like, WCI, 1DBI, ICICI, SIDBI, SFCs, Exim Bank etc. which are making a significant contribution to industry and trade of the country.
8. **Security to Depositors:** In order to remove the major hindrance to the deposit mobilization arisingout of frequent bank failures, the RBI took major initiative to set up the Deposit Insurance Corporation of India in 1962. The most important objective of this corporation is to provide security to the depositors against such failures.
9. **Advisory Functions:** The RBI is also providing advisory functions to both the Central and State Governments on both financial matters and also on general economic problems.
10. **Policy Support:** The RBI is also providing active policy support to the government through its investigation research on serious economic problems and issues of the country and thereby helps the Government to formulate its economic policies in a most rational manner.

Functions of SEBI

1. Regulatory Functions:

- Regulation of stock exchange and self-regulatory organisations.
- Registration and regulation of stock brokers, sub - brokers, registrar to all issue, merchant bankers, underwriters, portfolio managers and such other intermediaries who are associated with securities market.
- Registration and regulation of the working of collective investment schemes including mutual funds.
- Prohibit insider trading in securities.
- Regulating substantial acquisitions of shares and takeover of companies

2. Developmental Functions:

- Promote investor ' s education.
- Training of intermediaries
- Conducting research and published information useful to all market participants.
- Promotion of fair practices. Code of conduct for self-regulatory organisations.
- Promoting self-regulatory organisations.

Powers of SEBI

- SEBI has been vested with the following powers:
- Power to call periodical returns from recognised stock exchanges.

- Power to call any information or explanation from recognised stock exchanges or their members.
- Power to direct enquiries to be made in relation to affairs of stockexchanges or their members.
- Power to grant approval to bye - laws of recognised stock exchanges.
- Power to make or amend bye - laws of recognised stock exchanges.
- Power to compel listing of securities by public companies.
- Power to control and regulate stock exchanges.
- Power to grant registration to market intermediaries.
- Power to levy fees or other charges for carrying out the purpose ofregulation
- Power to declare applicability of Section 17 of the Securities Contract(Regulation) Act is any state or area to grant licenses to dealers in securities.

12. What is meant by CCIL, explain its functions.

- The Clearing Corporation of India Limited (CCIL) was registered on April 30, 2001 under the Companies Act, 1956. The State Bank of India is the chief promoter of the CCIL. Its other promoters are banks, financial institutions, and PDs.
- It has been set up as an ordinary, limited liability, non-government company under the Companies Act, 1956 with an equity capital of Rs. 50 crores.
- It functions like a business entity that is subject to corporate tax on its business profits. It acts as the central counter-party in the settlement of all trades in government securities, treasury bills, money market instruments, repos, inter-bank foreign exchange deals, and derivatives of any kind where the underlying instrument is a security or money market instrument.
- The CCIL is the clearing and settling agency in respect of all trades by institutional players such as banks, DFIs, primary dealers, mutual funds, corporates, and NBFCs who account for more than 98 per cent of the to also supports through its fully owned subsidiary, Clear Corp Dealing Systems (India) Ltd., three trading platforms in the forex and money market segments.
- It launched its forex dealing platform, FX-CLEAR on August 7, 2003 to meet the requirements of the inter-bank foreign exchange market in India.
- It developed an anonymous trading platform, NDS-OM in August 2005 to facilitate transparent and efficient trading in the government securities market.
- It launched an electronic screen-based quote driven dealing system NDS-CALL on September 18, 2006 for call, notice, and term money operations.
- After trade has been concluded on the negotiated dealing system (NDS), CCIL takes up the responsibility of settlement of trade via INFINET.
- During the settlement process, CCIL assumes certain risks, which may arise due to a default by a member to honour its obligations. For this, CCIL has designed the margining system and collects initial margin and mark to market (MTM) margin from members in respect of their outstanding trade.
- Initial margin covers the likely risk from future adverse movement of prices of the securities while mark to market margin covers the notional loss (i.e., the difference between the current market price and the contract price of the security covered by the trade) already incurred by any member.
- In addition, CCIL also collects volatility margin and operates a settlement guarantee fund (SGF) wherein each member contributes to it. CCIL has put in place settlement arrangements on the Securities and Forex segments.

- In the securities segment, the settlement operation has been switched over to DVP III mode with netting of both funds and securities which has facilitated the rollover of repos. This has enabled participants to buy and sell securities on the same day subject to the stipulations of the Reserve Bank.
- It has also enabled members to reduce the risks from failed trades arising out of the defaults by their counter-parties.
- By becoming central counter party to the trades done by its members, the CCIL absorbs risks.
- CCIL acts as a central counter-party for forex trading also. Every eligible foreign exchange contract entered into between members, gets novated and is replaced by two new contracts—between CCIL and each of the two parties, respectively.
- The rupee leg is settled through the member's current account with the Reserve Bank and the US Dollar leg through CCIL's account with the designated settlement banks at New York.
- The settlement through CCIL has reduced the gross dollar requirement by more than 90 per cent.
- The CCIL manages various risks such as credit and market risk, liquidity risk and operational risk to avoid serious system failures. In securities transactions, the CCIL covers the credit and market risk by making members maintain initial margins as well as mark-to-market margins to cover future adverse movements of securities and notional loss respectively.
- Members are required to maintain adequate balances in the settlement guarantee fund (SGF) in the form of eligible government securities/treasury bills and cash (minimum 10 per cent) to cover the margin requirements in respect of their trades.
- In foreign exchange transactions, the CCIL resorts to loss allocation mechanism to manage credit and market risk and restricts the membership to authorised dealers only.
- To ensure liquidity for uninterrupted settlements, CCIL has arranged rupee securities through member contributions to the SGF, rupee funds through line of credit with various banks, and US dollar funds by way of a fully collateralised line of credit with the settlement bank.
- It has commenced settlement of forex forward trades with guarantee from the trade date from October 20, 2008.
- To deal with operational risk, CCIL is developing a fully automated system for processing trades.
- A disaster recovery site is being set up at the Institute for Development and Research in Banking Technology (IDRBT), Hyderabad, to ensure business continuity in case of a disaster.
- The CCIL clears all transactions in government securities and repos reported on the NDS of the RBI and also rupee/USD free spot and forward deals.
- All repo transactions have to be necessarily put through the CCIL and all outright transactions up-to Rs. 20 crore have to be settled through the CCIL. Government securities trades up to Rs. 20 crore have to be settled compulsorily through the CCIL.
- Since most transactions are of a value below Rs. 20 crores, more than 80 per cent of the government securities transactions are compulsorily routed through the CCIL.
- This move is aimed at protecting retail investors in the government securities market against counter-party risks and defaults and enable higher retail participation in the government securities market.
- For larger transactions, the market players have the option of settling transactions either through the CCIL or directly through the SGL account system of the RBI.

- The RBI has asked banks to report all spot transactions in listed and unlisted non-SLR securities on the NDS and settle through the CCIL.
- This measure is expected to increase transparency in the non-SLR segment. The CCIL provides guarantee to non-SLR trades which will reduce default risks.
- There were 153 active members in CCIL's securities clearing settlement as on March 31, 2009. The size of the guarantee fund was Rs. 4,380.64 crores.
- The CCIL's turnover in the government securities segment increased to Rs. 62,54,579 crores in 2008–09 from Rs.26,92,129 crores in 2004–05.
- The CCIL cleared and settled an aggregate volume of Rs. 3,20,16,852 crores in 2008–09 across its securities, forex, and CBLO segments.
- The caps placed by the RBI on call money borrowings by banks and PDs, the increased activity in the repo market and the general upswing in the securities market boosted the CCIL's turnover.
- The CCIL proposes to launch a screen-based Repo Dealing System which would facilitate dealing in basket repos and special repos.
- Basket repo enables grouping of the underlying security into different baskets based on instrument category, liquidity and outstanding maturity profile.
- Special repo enables the borrowers/lenders to specify the security against which they want to borrow/lend.
- It is also developing a trading system and a system to undertake guaranteed settlement of trades in the IRS/FRA market.
- The CCIL, which offers clearing and settlement facilities for inter-institutional government securities transactions and inter-bank foreign exchange transactions, has been recognised as a systemically important payment system (SIPS).

13. Explain Common Securities Market in India.

The Securities Market, however, refers to the markets for those financial instruments / claims / obligations that are commonly and readily transferable by sale.

Figure 1.6: Structure of Securities Market

The Securities Market has two interdependent and inseparable segments, the new issues (primary) market and the stock (secondary) market.

- The Primary market provides the channel for sale of new securities. The issuer of securities sells the securities in the primary market to raise funds for investment and/or to discharge some obligation.

- The Secondary market deals in securities previously issued. The secondary market enables those who hold securities to adjust their holdings in response to charges in their assessment of risk and return.
- They also sell securities for cash to meet their liquidity needs. The price signals, which subsume all information about the issuer and his business including associated risk, generated in the secondary market, help the primary market in allocation of funds.

This secondary market has further two components.

- First, the spot market where securities are traded for immediate delivery and payment. The other is forward market where the securities are traded for future delivery and payment.
- This forward market is further divided into Futures and Options Market (Derivatives Markets).
- In futures Market the securities are traded for conditional future delivery whereas in option market, two types of options are traded.
- A put option gives right but not an obligation to the owner to sell a security to the writer of the option at a predetermined price before a certain date, while a call option gives right but not an obligation to the buyer to purchase a security from the writer of the option at a particular price before a certain date.

Securities Markets in India: An Overview

- The process of economic reforms and liberalization was set in motion in the mid-eighties and its pace was accelerated in 1991 when the economy suffered severely from a precariously low foreign exchange reserve, burgeoning imbalance on the external account, declining industrial production, galloping inflation and a rising fiscal deficit.
- The economic reforms, being an integrated process, included deregulation of industry, liberalization in foreign investment, regime, restructuring and liberalization of trade, exchange rate, and tax policies, partial disinvestments of government holding in public sector companies and financial sector reforms.
- The reforms in the real sectors such as trade, industry and fiscal policy were initiated first in order to create the necessary macroeconomic stability for launching financial sector reforms, which sought to improve the functioning of banking and financial institutions (FIs) and strengthen money and capital markets including securities market.

The securities market reforms specifically included:

- Repeal of the Capital Issues (Control) Act, 1947 through which Government used to expropriate and allocate resources from capital market for favored uses;
- Enactment of the Securities and Exchange Board of India Act, 1992 to provide for the establishment of the Securities and Exchange Board of India (SEBI) to regulate and promote development of securities market;
- Setting up of NSE in 1993, passing of the Depositories Act, 1996 to provide for the maintenance and transfer of ownership of securities in book entry form;
- Amendments to the Securities Contracts (Regulation) Act, 1956 (SCRA) in 1999 to provide for the introduction of futures and option.
- Other measures included free pricing of securities, investor protection measures, use of information technology, dematerialization of securities, improvement in trading practices, evolution of an efficient and transparent regulatory framework, emergence of several innovative financial products and services and specialized FIs etc.
- These reforms are aimed at creating efficient and competitive securities market subject to effective regulation by SEBI, which would ensure investor protection.

14. How Government influences the financial market?

Free markets are often conceptualized as having little to no interference from the government. However, in reality governments do step in to stabilize markets, regulate transactions, provide institutional frameworks, and enforce rules around contract law and property rights. Governments can also intervene when markets fail in the form of bailouts and other emergency measures.

Currency and Inflation

- Governments are the only entities that can legally create their respective currencies. When they can get away with it, governments will typically want to see inflation in the currency.
- Why? Because it provides a short-term economic boost as companies charge more for their products; it also reduces the value of the government bonds issued in the inflated currency and owned by investors.
- Inflated money feels good for a while, especially for investors who see corporate profits and share prices shooting up, but the long-term impact is an erosion of value across the board. Savings are worthless, punishing savers and bond buyers.
- For debtors, this is good news because they now have to pay less value to retire their debts—again, hurting the people who bought bank bonds based on those debts. This makes borrowing more attractive, but interest rates soon shoot up to take away that attraction.

Interest Rates

- Interest rates are another popular weapon, even though they are often used to counteract inflation. This is because they can spur the economy by making borrowing cheaper.
- Dropping interest rates via the Federal Reserve—as opposed to raising them—encourages companies and individuals to borrow and buy more.
- Unfortunately, this can also lead to asset bubbles where, unlike the gradual erosion of inflation, huge amounts of capital are destroyed, which brings us neatly to the next way the government can influence the market.

Bailouts

- Bailouts can skew the market by changing the rules to allow poorly run companies to survive. Often, these bailouts can hurt shareholders of the rescued company or the company's lenders.
- In normal market conditions, these firms would go out of business and see their assets sold to more efficient firms to pay creditors and, if possible, shareholders. Fortunately, the government only uses its ability to protect the most systemically essential industries like banks, insurers, airlines, and car manufacturers.

Subsidies and Tariffs

- Subsidies and tariffs are essentially the same things from the perspective of the taxpayer. In the case of a subsidy, the government taxes the general public and gives the money to a chosen industry to make it more profitable.
- In the case of a tariff, the government applies taxes to foreign products to make them more expensive, allowing the domestic suppliers to charge more for their products. Both of these actions have a direct impact on the market.

Regulations and Corporate Tax

- The business world rarely complains about bailouts to certain industries, perhaps because of the knowledge that their industry may one day need help as well. But Wall Street does object when it comes to regulations and taxes. That's because while subsidies and tariffs can give an industry a comparative advantage, regulations and taxes can negatively impact profits.

- High taxes on corporate profits have a different effect in that they may discourage companies from coming into the country. Just as states with low taxes can lure away companies from their neighbours, countries that tax less will tend to attract any mobile corporations. Worse yet, the companies that can't move end up paying the higher tax and are at a competitive disadvantage in business as well as in attracting investor capital.

What Is the Role of Government in Markets According to Libertarianism?

Libertarianism is a political and economic ideology that advocates for free markets, low taxes, and limited government. Following the writings of Adam Smith, strict libertarians see the government as responsible for just a few primary functions:

- To protect and enforce private property rights
- To maintain a domestic police force to keep citizens safe
- To maintain a standing army to protect the nation's borders and interests
- To build public works (e.g., schools and parks) that would benefit society but the free market wouldn't be incentivized to otherwise build

Why Do Governments Need to Impose Certain Regulations?

- Free markets only work efficiently if there is full information (what economists call "perfect information") among all participants, including buyers and sellers, producers and consumers. However, in reality, some sellers may be fraudsters and companies may cut corners to produce shoddy products.
- This is known as an information asymmetry. While the market may eventually identify and sanction such bad actors, in the meantime consumers may be significantly harmed, both economically and otherwise.
- Therefore, regulations are put in place to rectify the information asymmetry and protect consumers.

UNIT II INDIAN CAPITAL MARKET- PRIMARY MARKET

Primary Market - Primary market system - Types of scripts - Issue of capital: process, regulation pricing of issue, – Methods of floating new issues, Book building- Primary markets intermediaries: commercial banks, development banks, Merchant banker, issue managers, rating agencies etc – Role of primary market – Regulation of primary market.

PART – A

1. **Define Primary Market.**

The primary market is a market for new issues. It is also called the new issues market. It is a market for fresh capital. Funds are mobilized in the primary market through prospectus, rights issues, and private placement.

2. **List the features of Primary Market.**

- ✓ In the primary market companies issue securities directly to investors.
- ✓ After receiving the prescribed funds, the company allots share/securities to the investors.
- ✓ Primarymarketfacilitatescompaniestoraisecapitalforsettingnewbusinessventures, or for expanding or modernizing existing business.

3. **What is Bonus Issue?**

Bonus issue is also one of the ways to raise capital but it does not bring in any fresh capital. Some companies distribute profit to existing shareholders by the way of fully paid bonus shares instead of paying them a dividend. Bonus shares are issued in the ratio of the existing shares held.

4. **Discuss the reasons for issuing bonus.**

- ✓ To boost liquidity of their stock
- ✓ To bring down the stock price
- ✓ To restructure their capital.

5. **List the participants involved in primary market.**

- ✓ Issuers of securities,
- ✓ Investors in securities,
- ✓ Intermediaries.

6. **Who are the intermediaries to the issue?**

There are different intermediaries to an issue such as merchant bankers or book running lead managers (BRLM), syndicate members, registrars to the issue, bankers to the issue, auditors of the company and solicitors. The issuer discloses the addresses, telephone, fax numbers and email addresses of these intermediaries.

7. Who is Merchant Banker?

A merchant banker should be registered with the SEBI as per the SEBI (Merchant Bankers) Regulations, 1992 to act as a book running lead manager (BRLM) to an issue. The lead merchant banker performs most of the pre-issue and post-issue activities.

8. What are the pre-issue activities?

The pre-issue activities of the lead manager include due diligence of company's operations/management/business plans/legal etc., drafting and designing offer document, finalizing the prospectus, drawing up marketing strategies for the issue, and ensuring compliance with stipulated requirements and completion of prescribed formalities with the stock exchanges and the Registrar of Companies (ROC).

9. What are the post-issue activities?

The post-issue activities include management of escrow accounts, coordinating, non-institutional allocation, intimation of allocation, coordination with the registrar for dispatching of refunds, dematerializing of securities, listing and trading of securities, and coordinating the work of other intermediaries involved in the issue process.

10. What is the role of registrar to the issue?

The role of the registrar is to finalize the list of eligible allottees, ensure crediting of shares to the demat accounts of the eligible allottees, and dispatch refund orders.

11. Discuss the roles performed by bankers to the issue.

They are appointed in all the mandatory collection centres and by the lead merchant banker to carry out activities relating to collection of application amounts, transfer of this amount to escrow accounts, and dispatching refund amounts.

12. List the types of primary issues.

- ✓ Public Issues,
- ✓ Right issues and
- ✓ Private Placement

13. Define Public Issue.

When a company raises funds by selling (issuing) its shares (or debenture / bonds) to the public through issue of offer document (prospectus), it is called a public issue.

- ✓ Initial Public Offering (IPO) - IPO is an offering when an unlisted company makes either a fresh issue of securities.
- ✓ Further public offering (FPO) - An FPO is made when an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, through an offer document.

14. Define Rights issue.

Right issue is the issue of new securities in which the existing shareholders are given the pre-emptive rights to subscribe to the new issue on a pro-rata basis. In the right issues existing share holders have given the rights to subscribe to a proportionate number of fresh, extra shares at a pre-determined price.

15. How funds are raised through private placement?

In case of private placement securities are directly offer to the small numbers of investors through merchant bankers. These investors are the selected clients such as financial institutions, banks, corporate and high net worth individuals. Company law defines a privately placed issue to be the one seeking subscription from 50 members. In private placement no prospectus is issued.

16. Define Preferential Issue.

A preferential issue means an issue of specified securities by listed companies to a selected group of persons on a private placement basis and does not include an offer of securities made through a public issue, right issue, bonus issue; employees took option scheme, employee stock purchase scheme.

17. What is meant by Qualified Institution Placement (QIP)?

In a QIP, a listed issuer issues equity shares or non-convertible debt instruments along with warrants and convertible securities other than warrants to Qualified Institutional Buyers only on private placement basis.

18. List the methods of floating new issues.

- ✓ Public issue/ Offer for sale:
- ✓ Book Building Process
- ✓ Private Placement
- ✓ Issue of Indian Depository Receipts (IDR)
- ✓ Rights issue (RI)
- ✓ Bonus Issue

19. What is book building process?

Book building is actually a price discovery method. In this method, the company doesn't fix up a particular price for the shares, but instead gives a price range, e.g. Rs 80-100. When bidding for the shares, investors have to decide at which price they would like to bid for the shares, for e.g. Rs 80, Rs 90 or Rs 100. They can bid for the shares at any price within this range.

20. Define IDR.

Issue of Indian Depository Receipts (IDR): A foreign company which is listed in stock exchange abroad can raise money from Indian investors by selling (issuing) shares. These shares are held in trust by a foreign custodian bank against which a domestic custodian bank issues an instrument called Indian depository receipts.

21. What are the roles performed by underwriters?

Another important intermediary in the new issue market is the underwriters to issues of capital who agree to take up securities which are not fully subscribed. They assure that the issue will be subscribed either by others or by themselves.

22. Who are debenture trustees?

A debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company or a body corporate or any private placement of debentures by a listed or proposed to be listed company. A trust deed means the deed executed by the body corporate in favor of the trustees named therein for the benefit of the debenture holders.

23. Who is called as portfolio managers?

Portfolio managers are the persons who made a contract or agreement with the clients to advise/direct/ undertake, on behalf of clients to act as discretionary portfolio manager or Non-discretionary portfolio manager for the management of the portfolio of securities of the clients.

24. What is discretionary portfolio management?

In discretionary portfolio management the manager uses his discretion with regards to the management / investments of the clients on behalf of the investors.

25. What is non-discretionary portfolio management?

In non- discretionary portfolio management, the manager manages funds in accordance to the directions of the clients.

26. Discuss the functions of NIM.

- ✓ Origination - It refers to the work of investigation and analysis and processing of new proposals.
- ✓ Underwriting -Underwriting entails an agreement whereby a person/organization agrees to take a specified number of shares or debentures or a specified amount of stock offered to the public in the event of the public not subscribing to it, in consideration of a commission.
- ✓ Distribution - The sale of securities to the ultimate investors is referred to as distribution.

27. List the main functions of SEBI.

- ✓ To regulate the business of the stock market and other securities market.
- ✓ To promote and regulate the self-regulatory organizations.
- ✓ To prohibit fraudulent and unfair trade practices in securities market.
- ✓ To promote awareness among investors and training of intermediaries about safety of market.
- ✓ To prohibit insider trading in securities market.
- ✓ To regulate huge acquisition of shares and takeover of companies.

28. How is the pricing of an issue done?

- ✓ Fixed Price Issue: In a fixed price issue of shares to the public, the company in consultation with the Investment Banker would decide on the price at which the shares will be issued. The company justifies the price based on the expected performance of the company and the price of shares of comparable companies in the market.
- ✓ Book Built Issue: The objective of a book building process is to identify the price that the market is willing to pay for the securities being issued by the company.

29. What are the Regulatory Norms of SEBI for Public Issue of Shares?

- ✓ A public issue will be open for a minimum of three working days and a maximum of 10 working days in the case of fixed price issues.
- ✓ For book built issues, the offer will be open for a period between 3 to 7 days extendable by 3 days in case of a revision in price band.
- ✓ Companies making a public offer of shares are required to get the IPO graded by a credit rating agency registered with SEBI. The grading is done based on the prospects of the industry, the competitive strength of the company and risks in the business.

30. What are the regulations of Primary Markets?

The primary markets are regulated by the Companies Act, 2013, Securities and Contract Regulation Act, 1956, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 for issue of equity and debt securities by companies. Disclosure of All Material Facts is made Compulsory

- ✓ Encouragement to Initial Public 0ffers
- ✓ Increase of Popularity to Private Placement Market
- ✓ Underwriting has made Optional
- ✓ Issue of Due Diligence Certificate

PART – B

1. Define primary market. Briefly explain the types of issues in primary market.

A financial market is a broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives.

A capital market is one in which individuals and institutions trade financial securities.

Stock markets allow investors to buy and sell shares in publicly traded companies.

Securities market is an economic institute within which takes place the sale and purchase transactions of securities between subjects of the economy, on the basis of demand and supply.

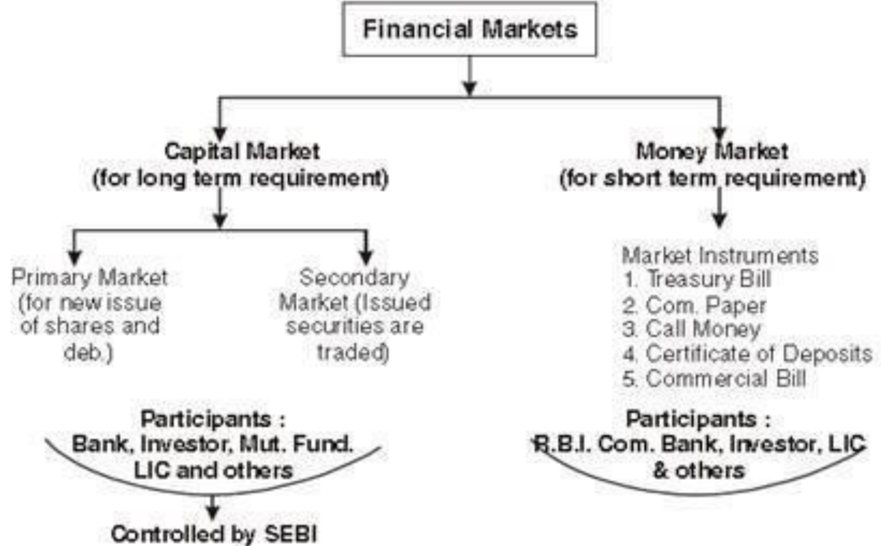


Figure 2.1 Types of Financial Markets

Primary Market:

The primary market is a market for new issues. It is also called the new issues market. It is a market for fresh capital. Funds are mobilized in the primary market through prospectus, rights issues, and private placement. Bonus issue is also one of the ways to raise capital but it does not bring in any fresh capital.

- ✓ New issues market where Company/ institutions raise funds or capital from public by issuing new securities.
- ✓ Objective: To raise capital.
- ✓ Two major types of issuers of securities:
  - ➢ Corporate Entities (Companies)
  - ➢ Government (Central and State)
- ✓ Major types of Issues in Primary Market:
  - ➢ Public Issue
  - ➢ Preferential Issue
  - ➢ Rights Issue
  - ➢ Bonus Issue

Objects of issues in primary market:

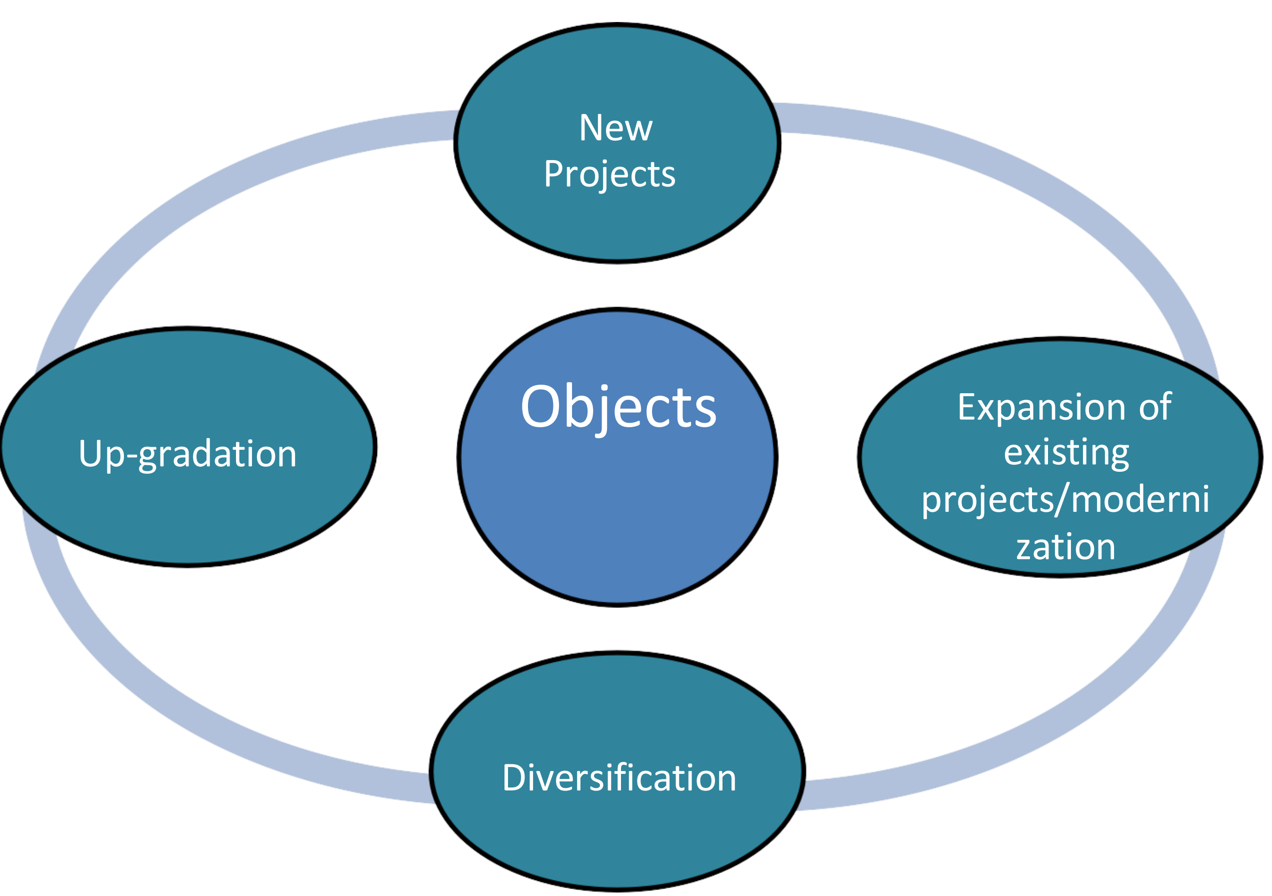


Figure 2.3 Objects of issue of capitals in Primary Market

The process of selling the new securities, in the primary market is called **underwriting**, which is performed by a group called as underwriters or security dealers.

The underwriting service is offered by financial institutions such as investment banks, insurance companies, etc. The underwriting companies guarantee payment if there is any loss and accepts the risk which occurs as a consequence of such guarantee.

The main function of the primary market is to mobilize the investible money from the savers to the companies or young entrepreneurs who seek funds to set up new businesses or expand the existing venture, by issuing securities.

Types of Issue of Securities in Primary Market:

There are several types of issue of securities in the primary market which are discussed as under:

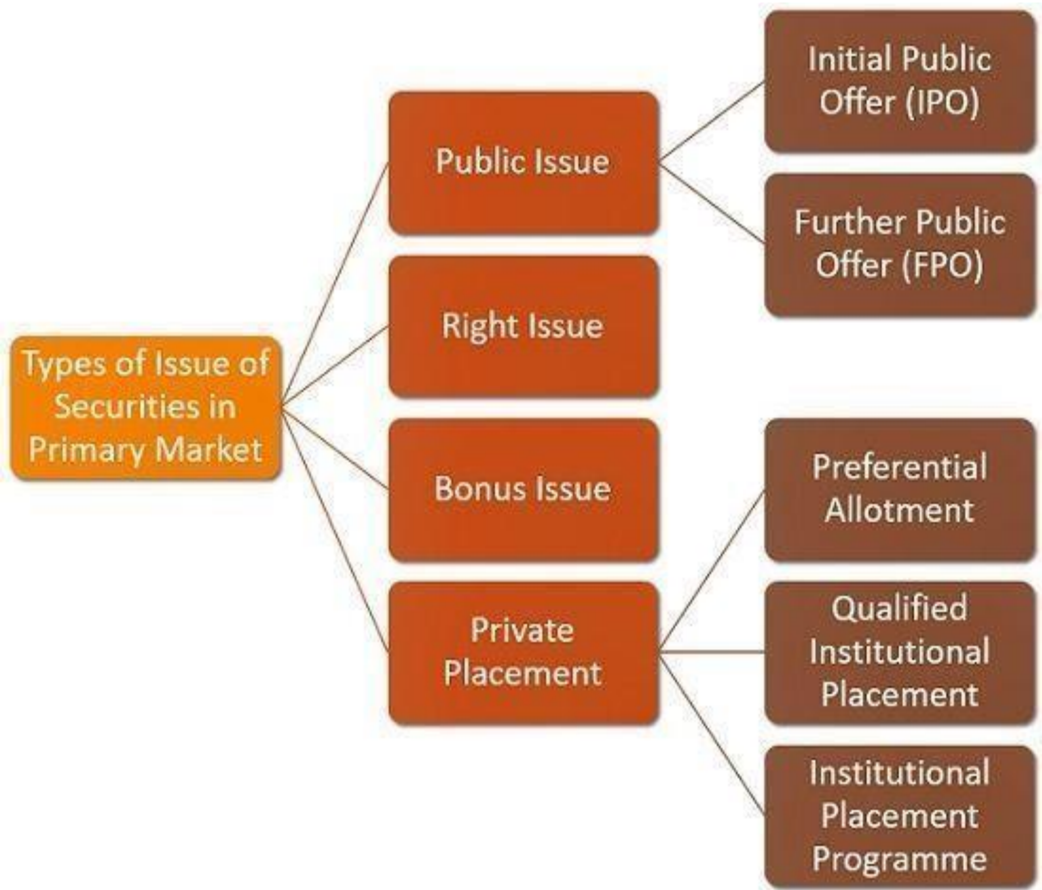


Figure 2.4 Types of issue of capitals in Primary Market

Public Issue: Public issue is when a company enters the market, to raise money from all kinds of investors. The securities offered for sale to the new investors, so as to become a shareholder in the issuer company, is called Public Issue.

- ✓ **Initial Public Offer**: Initial Public Offer or IPO, as the name suggests, is the fresh issue of equity shares or convertible securities, or exiting shares or convertible securities by an unlisted company for the very first time i.e. the shares are not previously traded or offered for sale to the general public. This is often followed by listing and trading of the company's securities on the stock exchange.

- ✓ **Further Public Offer**: Otherwise called as **Follow on offer** or FPO, refers to the fresh issue of securities to the general public made by a company already listed on the stock exchange, so as to raise additional funds.

Right Issue: Right Issue is an offer to the company's existing shareholders to buy further new shares of the company at a discount, as a part of the dividend of pre-emption rights. It helps the firms to raise additional funds, without going to the public. It invites its existing shareholders to subscribe for its fresh issue in the proportion of their shareholdings on the record date in the concern.

Bonus Issue: When a company issues fully paid additional shares to the company's existing shareholders for free. The issue is made from the company's free reserves or securities premium account, in a specific proportion to the shareholding on a specific record date.

Private Placement: When a company's stocks or bonds are sold directly to a selected group of people, say 50 to 200 people, called as private investors or institutions, instead of offering the same to the general public is called private placement. Hence, in case of a private placement there are only a handful of subscribers to the company's shares. However, it is capable of raising money, more quickly as compared to offering shares for sale in the open market.

- ✓ **Preferential Allotment**: Preferential Issue is one in which the specified securities are allotted by a listed company to a selected group on a preferential basis. The issuing company needs to adhere to the provisions relating to pricing, lock-in period, disclosures, and so on.

- ✓ **Qualified Institutional Placement**: When a company, which is already listed in a stock exchange issues shares or debentures (fully or partly convertible) or any other kind of security not including warrants, which are convertible in nature, to **Qualified Institutional Buyer (QIB),** is called as Qualified Institutional Placement (QIP).

- ✓ **Institutional Placement Programme**: Institution Placement Programme or IPP implies a further public issue of equity shares by a listed firm or group of promoters of a listed company, wherein the offer and allocation are made to **Qualified Institutional Buyers** only.

2. What is meant by issue of capital, explain the procedure involved in issue of capital in primary market.

The Issue of capital refers to the number of shares issued by the company to the shareholders. In other words, the shares allotted or subsequently held by the shareholders are called the issue of capital.

Issue of Shares is the process in which companies allot new shares to shareholders. Shareholders can be either individuals or corporates. The company follows the rules prescribed by Companies Act 2013 while issuing the shares. Issue of Prospectus, Receiving Applications, and Allotment of Shares are three basic steps of the procedure of issuing the shares. The process of creating new shares is known as Allocation or allotment. Let us see the two types of shares of a company and the procedure for issue of shares that a company must follow.

Procedure of Issue of New Shares

Issue of Prospectus

Before the issue of shares, comes the issue of the prospectus. The prospectus is like an invitation to the public to subscribe to shares of the company. A prospectus contains all the information of the company, its financial structure, previous year balance sheets and profit and Loss statements etc.

It also states the manner in which the capital collected will be spent. When inviting deposits from the public at large it is compulsory for a company to issue a prospectus or a document in lieu of a prospectus.

Receiving Applications

When the prospectus is issued, prospective investors can now apply for shares. They must fill out an application and deposit the requisite application money in the schedule bank mentioned in the prospectus. The application process can stay open a maximum of 120 days. If in these 120 days' minimum subscription has not been reached, then this issue of shares will be cancelled. The application money must be refunded to the investors within 130 days since issuing of the prospectus.

Allotment of Shares

Once the minimum subscription has been reached, the shares can be allotted. Generally, there is always oversubscription of shares, so the allotment is done on pro-rata bases. Letters of Allotment are sent to those who have been allotted their shares. This results in a valid contract between the company and the applicant, who will now be a part owner of the company.

If any applications were rejected, letters of regret are sent to the applicants. After the allotment, the company can collect the share capital as it wishes, in one go or in installments.

3. Explain the Book Building process in issue of capital.

Book building is the process by which an underwriter attempts to determine the price at which an initial public offering (IPO) will be offered. An underwriter, normally an investment bank, builds a book by inviting institutional investors (such as fund managers and others) to submit bids for the number of shares and the price(s) they would be willing to pay for them.

Book building has surpassed the 'fixed pricing' method, where the price is set prior to investor participation, to become the de facto mechanism by which companies price their IPOs. The process of price discovery involves generating and recording investor demand for shares before arriving at an issue price that will satisfy both the company offering the IPO and the market. It is highly recommended by all the major stock exchanges as the most efficient way to price securities.

The book building process comprises these steps:

- ✓ The issuing company hires an investment bank to act as an underwriter who is tasked with determining the price range the security can be sold for and drafting a prospectus to send out to the institutional investing community.

- ✓ The investment bank invites investors, normally large scale buyers and fund managers, to submit bids on the number of shares that they are interested in buying and the prices that they would be willing to pay.

- ✓ The book is 'built' by listing and evaluating the aggregated demand for the issue from the submitted bids. The underwriter analyzes the information and uses a weighted average to arrive at the final price for the security, which is termed the cutoff price.

- ✓ The underwriter has to, for the sake of transparency; publicize the details of all the bids that were submitted.
- ✓ Shares are allocated to the accepted bidders.
- ✓ Even if the information collected during the book building process suggests a particular price point is best, that does not guarantee a large number of actual purchases once the IPO is open to buyers. Further, it is not a requirement that the IPO be offered at that price suggested during the analysis.

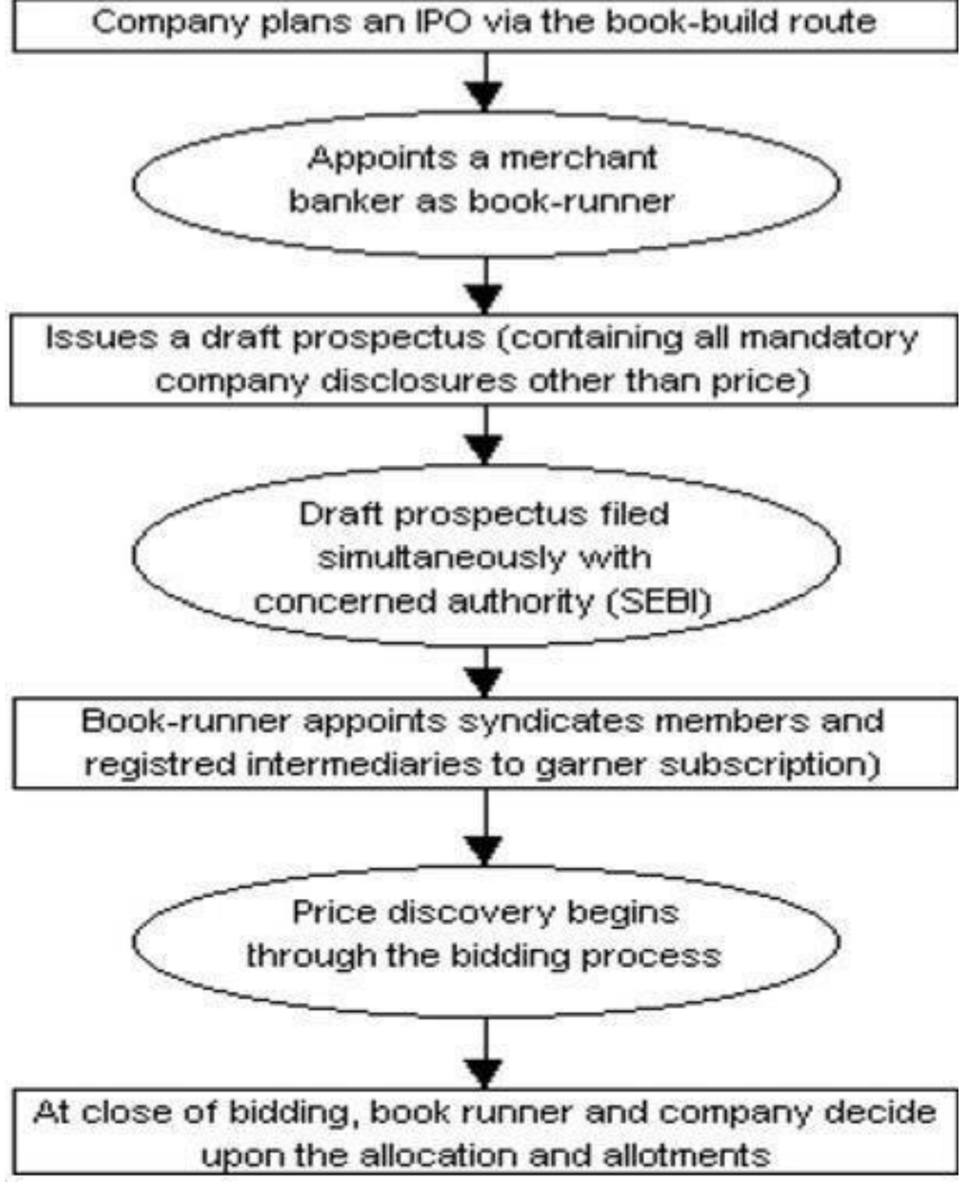


Figure 2.5 Process of Book Building

Accelerated Book Building

An accelerated book-build is often used when a company is in immediate need of financing, in which case, debt financing is out of the question. This can be the case when a firm is looking to make an offer to acquire another firm.

Basically, when a company is unable to obtain additional financing for a short-term project or acquisition due to its high debt obligations, it can use an accelerated book-build to obtain quick financing from the equity market.

With an accelerated book build, the offer period is open for only one or two days and with little to no marketing. In other words, the time between pricing and issuance is 48 hours or less.

A book build that is accelerated is frequently implemented overnight, with the issuing company contacting a number of investment banks that can serve as underwriters on the evening prior to the intended placement.

The issuer solicits bids in an auction-type process and awards the underwriting contract to the bank that commits to the highest backstop price. The underwriter submits the proposal with the price range to institutional investors. In effect, placement with investors happens overnight with the security pricing occurring most often within 24 to 48 hours.

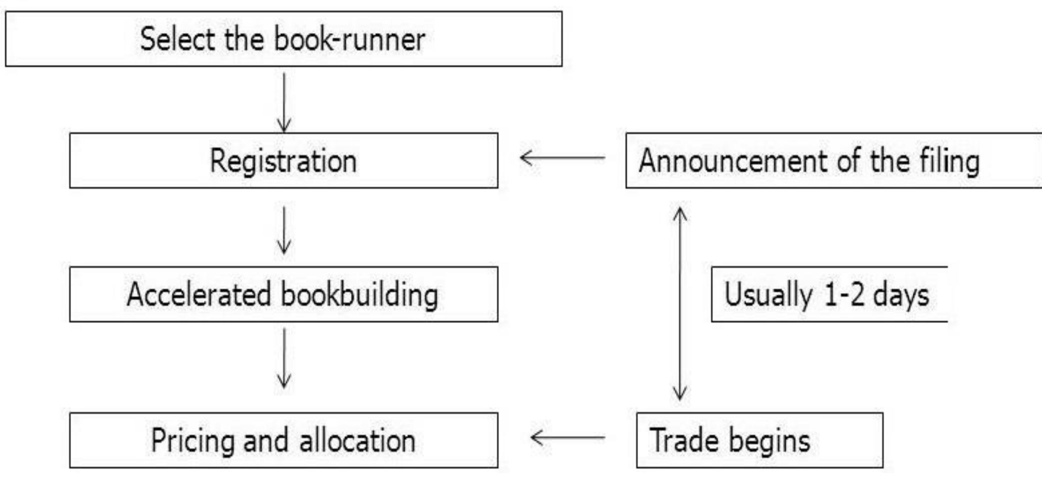


Figure 2.6 Process of Accelerated Book Building

IPO Pricing Risk

With any IPO, there is a risk of the stock being overpriced or undervalued when the initial price is set. If it is overpriced, it may discourage investor interest if they are not certain that the company’s price corresponds with its actual value. This reaction within the marketplace can cause the price to fall further, lowering the value of shares that have already been secured.

In cases where a stock is undervalued, it is considered to be a missed opportunity on the part of the issuing company as it could have generated more funds than were acquired as part of the IPO.

Reverse Book Building

Reverse book building is a process wherein the shareholders are asked to bid for the price at which they are willing to offer their shares. It is just similar to the reverse auction. This process helps in discovering the exit price and is used by companies who want to delist their shares or buy-back shares from the shareholders. In the reverse auction process, the promoter appoints a merchant banker and also a trading member for placing bids on the online electronic system.

Figure 2.6 Process of Reverse Book Building

Difference between shares offered through Book Building and Fixed Price Issue of the public issues.

Features	Fixed Price Issue	Book Building Issue
Offer Price	Price at which the securities are offered and would be allotted is made known in advance to the investors.	A 20% price band is offer within which investors are allowed to bid and final price is determined by the issuer only after closure of bidding.
Demand	Demand for securities offered is known at the closure of the issue	In case book building, the demand can be known everyday as the book is built or during the bidding period.
Payment	100% advance payment is required to be made by the investors at the time of application.	10% advance payment is required to be made by QIBs along with the application, while other categories of investors have to pay 100% advance along with the application.

Table: 2.1 Differences between Fixed Price Issue and Book Building Issue

4. Explain the Green-Shoe Option (GSO) process in issue of capital.

A green-shoe option is an over-allotment option. In the context of an initial public offering (IPO), it is a provision in an underwriting agreement that grants the underwriter the right to sell investors more shares than initially planned by the issuer if the demand for a security issue proves higher than expected.

- A green-shoe option was first used by the Green Shoe Manufacturing Company (now part of Wolverine World Wide, Inc.)
- Green-shoe options typically allow underwriters to sell up to 15% more shares than the original issue amount.
- Green-shoe options provide price stability and liquidity.
- Green-shoe options provide buying power to cover short positions if prices fall, without the risk of having to buy shares if the price rises.

How a Green-shoe Option Works?

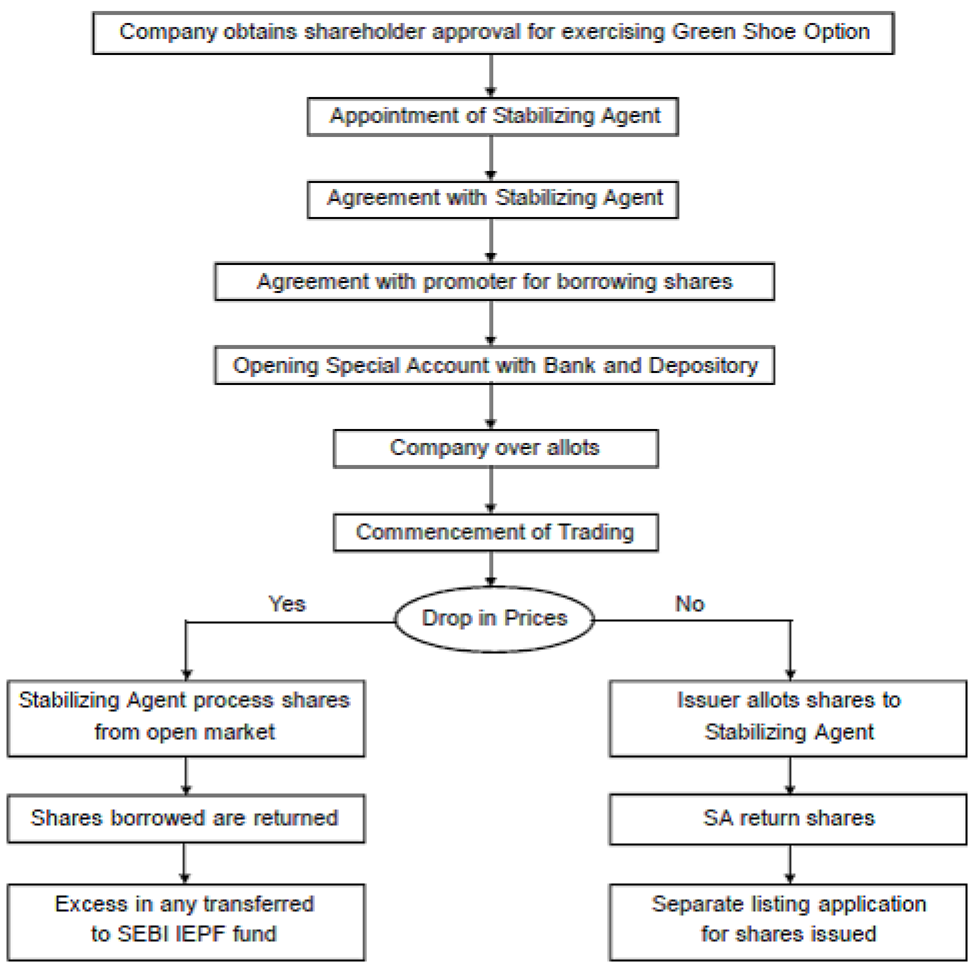


Figure 2.7 Process of GSO

Over-allotment options are known as green-shoe options because, in 1919, Green Shoe Manufacturing Company (now part of Wolverine World Wide, Inc. (WWW) as Stride Rite) was the first to issue this type of option. A green-shoe option provides additional price stability to a security issue because the underwriter can increase supply and smooth out price fluctuations. It is the only type of price stabilization measure permitted by the Securities and Exchange Commission (SEC).

Green-shoe options typically allow underwriters to sell up to 15% more shares than the original amount set by the issuer for up to 30 days after the IPO if demand conditions warrant such action.

For example, if a company instructs the underwriters to sell 200 million shares, the underwriters can issue if an additional 30 million shares by exercising a green-shoe option (200 million shares x 15%). Since underwriters receive their commission as a percentage of the IPO, they have the incentive to make it as large as possible. The prospectus, which the issuing company files with the SEC before the IPO, details the actual percentage and conditions related to the option.

Underwriters use green-shoe options in one of two ways. First, if the IPO is a success and the share price surges, the underwriters exercise the option, buy the extra stock from the company at the predetermined price, and issue those shares, at a profit, to their clients. Conversely, if the price starts to fall, they buy back the shares from the market instead of the company to cover their short position, supporting the stock to stabilize its price.

Some issuers prefer not to include green-shoe options in their underwriting agreements under certain circumstances; such as if the issuer wants to fund a specific project with a fixed amount and has no requirement for additional capital.

Examples of Green-shoe Option

A well -known example of a green-shoe option at work occurred in Face book Inc., now Meta (META), IPO of 2012. The underwriting syndicate, headed by Morgan Stanley (MS), agreed with Face book, Inc. to purchase 421 million shares at $38 per share, less a 1.1% underwriting fee. However, the syndicate sold at least 484 million shares to clients—15% above the initial allocation, effectively creating a short position of 63 million shares.

If Face book shares had traded above the $38 IPO price shortly after listing, the underwriting syndicate would've exercised the green-shoe option to buy the 63 million shares from Face book at $38 to cover their short position and avoid having to repurchase the shares at a higher price in the market.

However, because Face book's shares declined below the IPO price soon after it commenced trading, the underwriting syndicate covered their short position without exercising the green-shoe option at or around $38 to stabilize the price and defend it from steeper falls.

5. Discuss the various methods of floating in New Issue Market.

PRIMARY MARKET

The market mechanism for buying and selling of new issues of securities is known as NIM. When a new company is floated, its shares are traded to the public in the primary market as initial public offerings.

FEATURES OF PRIMARY MARKET

- ✓ This is the market for new long term equity capital. The primary market is the market where the securities are sold for the first time. Therefore, it is also called the new issue market (NIM).
- ✓ In a primary issue, the securities are issued by the company directly to investors.
- ✓ The company receives the money and issues new security certificates to the investors.
- ✓ Primary issues are used by companies for the purpose of setting up new business or for expanding or modernizing the existing business.
- ✓ The primary market performs the crucial function of facilitating capital formation in the economy.
- ✓ The new issue market does not include certain other sources of new long term external finance, such as loans from financial institutions. Borrowers in the new issue market may be raising capital for converting private capital into public capital; this is known as "going public."
- ✓ The financial assets sold can only be redeemed by the original holder.

METHODS OF FLOATING NEW ISSUES IN THE PRIMARY MARKET

A. Public issue/ Offer for sale:

When a company raises funds by selling (issuing) its shares (or debenture / bonds) to the public through issue of offer document (prospectus), it is called a public issue. Initial Public Offer (IPO): When a (unlisted) company makes a public issue for the first time and gets its shares listed on stock exchange, the public issue is called as initial public offer (IPO).

Follow-on public offer (FPO): When a listed company makes another public issue to raise capital, it is called follow-on offer (FPO). Institutional investors like venture funds, private equity funds etc., invest in unlisted company when it is very small or at an early stage. Subsequently, when the company becomes large, these investors sell their shares to the public, through issue of offer document and the company’s shares are listed in stock exchange. This is called as offer for sale. The proceeds of this issue go the existing investors and not to the company.

B. Book Building Process

Book building is actually a price discovery method. In this method, the company doesn't fix up a particular price for the shares, but instead gives a price range, e.g. Rs 80 -100. When bidding for the shares, investors have to decide at which price they would like to bid for the shares, for e.g. Rs 80, Rs 90 or Rs 100. They can bid for the shares at any price within this range. Based on the demand and supply of the shares, the final price is fixed. The lowest price (Rs 80) is known as the floor price and the highest price (Rs 100) is known as cap price. The price at which the shares are allotted is known as cut off price. The entire process begins with the selection of the lead manager, an investment banker whose job is to bring the issue to the public.

The Process:

- ✓ The Issuer who is planning an offer nominates lead merchant banker(s) as 'book runners'.
- ✓ The Issuer specifies the number of securities to be issued and the price band for the bids.
- ✓ The Issuer also appoints syndicate members with whom orders are to be placed by the investors.
- ✓ The syndicate members input the orders into an 'electronic book'. This process is called 'bidding' and is similar to open auction.
- ✓ The book normally remains open for a period of 5 days.
- ✓ Bids have to be entered within the specified price band.
- ✓ Bids can be revised by the bidders before the book closes.
- ✓ On the close of the book building period, the book runners evaluate the bids on the basis of the demand at various price levels.
- ✓ The book runners and the Issuer decide the final price at which the securities shall be issued.
- ✓ Generally, the number of shares is fixed; the issue size gets frozen based on the final price per share.
- ✓ Allocation of securities is made to the successful bidders. The rest get refund orders.

C. Private Placement:

The sale of securities to a relatively small number of select investors for raising capital. Investors involved in private p placements are usually large banks, mutual funds, insurance companies and pension funds. Private placement is the opposite of a public issue, in which securities are made available for sale on the open market.

D. Issue of Indian Depository Receipts (IDR):

A foreign company which is listed in stock exchange abroad can raise money from Indian investors by selling (issuing) shares. These shares are held in trust by a foreign custodian bank against which a domestic custodian bank issues an instrument called Indian depository receipts (IDR). IDR can be traded in stock exchange like any other shares and the holder is entitled to rights of ownership including receiving dividend.

E. Rights issue (RI):

When a company raises funds from its existing shareholders by selling (issuing) them new shares / debentures, it is called as rights issue. The offer document for a rights issue is called as the Letter of Offer and the issue is kept open for 30-60 days. Existing shareholders are entitled to apply for new shares in proportion to the number of shares already held. f. Bonus Issue: The company issues new share to its existing shareholders is called as the bonus shares. As the new shares are issued out of the company's reserves (accumulated profits), shareholders need not pay any money to the company for receiving the new shares.

6. Briefly explain the financial intermediaries involved in NIM.

The most important aspect regarding the whole process of selling new issues has been boosted by the emergence of variety of intermediaries and it is one of the most crucial organizational developments in the Indian primary market. The major new issue market intermediaries are merchant banker/lead managers, underwriters, bankers to an issue, registrars, and share transfer agents, debenture trustees and portfolio managers.

Merchant banker/ Lead manager

Merchant banker requires compulsory registration with the SEBI as per the SEBI (Merchant Banker) Regulations, 1992 to act as book running lead manager (BRLM) to an issue. The lead manager performs the pre -issue as well as post- issue activities. Issue means an offer for sale of securities by body corporate to public or to the existing holders of the securities through the merchant banker. The pre-issue activities include the preparation of prospectus and other information relating to the issue, determining the financial structure, tie-up of financiers, appointment of registrars to deal with share application and transfers, arrangement of underwriting / sub-underwriting, placing of issue, selection of brokers and bankers to the issue, drawing up marketing strategies for the issue, compliance of procedural formalities with the stock exchanges and Registrar of Companies (ROC). Post-issue activities include management of escrow accounts, coordinating, non-institutional allocation, Intimation of allocation, coordination with the registrar for dispatching of refunds, dematerializing of securities, listing and trading of securities and coordinating with the other intermediaries involved in the issue process.

Underwriters

Another important intermediary in the new issue market is the underwriters to issues of capital who agree to take up securities which are not fully subscribed. They assure that the issue will be subscribed either by others or by themselves. To act as an underwriter, a certificate of registration must be obtained from the SEBI. Underwriting is not mandatoryafterApril1995, but its organisation is an important element of the primary market.

Underwriters of the issues are appointed by the companies in the consultation with lead manages / merchant bankers of the issues. Merchant bankers' statement regarding that the underwriters' assets are adequate to meet their obligation should be incorporated in the prospectus.

Bankers to an Issue

Bankers to an Issue are appointed in all the collection centres and by the merchant bankers to perform the activities such as collection of application money from the investors, transfer of this amount to escrow account, and refund of application money.

Registrar to an Issue and Share Transfer Agents

Registrar to an Issue and Share Transfer Agents must have obtained a certificate of registration from the SEBI on payment of the requisite fees. Registrar to an issue carry out the activities such as collecting of applications from the investors, keeping a proper record of applications and money received from investors or paid to the seller of securities and assisting companies in determining the basis of allotment of securities in consultation of stock exchanges, finalizing the allotment of securities, dispatching allotment letters, refund orders, certificates and other related documents in respect of issues. Share transfer agents maintain the records of holders of securities or on behalf of companies and deal with activities related to the transfer/redemption of its securities.

Debenture Trustees

A debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company or a body corporate or any private placement of debentures by a listed or proposed to be listed company. A trust deed means the deed executed by the body corporate in favor of the trustees named therein for the benefit of the debenture holders. Only banks, public financial institutions, insurance companies and body corpora1tes fulfilling the capital adequacy requirement of Rs. 2 crores in terms of net worth as per the latest audited balance sheet can act as trustee. Like other intermediary's debenture trustees need to get registration with the SEBI on payment of requisite fees.

Portfolio Managers

Portfolio managers are the persons who made a contract or agreement with the clients to advise/direct/ undertake, on behalf of clients to act as discretionary portfolio manager or Non-discretionary portfolio manager for the management of the portfolio of securities of the clients. In discretionary portfolio management the manager uses his discretion with regards to the management / investments of the clients on behalf of the investors whereas in non-discretionaryportfoliomanagementthemanagermanagesfundsinaccordancetothedirectionsof the clients.

7. Explain the functions of NIM.

The market mechanism for buying and selling of new issues of securities is known as NIM. When a new company is floated, its shares are traded to the public in the primary market as initial public offerings (IPOs).

Functions of NIM:

Origination:

It refers to the work of investigation and analysis and processing of new proposals. This in turn may be:

(i) A preliminary investigation undertaken by the sponsors (specialized agencies) of the issue. This involves a careful study of the technical, economic, financial and legal aspects of the issuing companies to ensure that it warrants the backing of the issue house.

(ii) Services of an advisory nature which go to improve the quality of capital issues. These services include advice on such aspects of capital issues as:

- ✓ Determination of the class of security to be issued and price of the – issue in terms of market conditions
- ✓ The timing and magnitude of issues
- ✓ Method of flotation, and
- ✓ Technique of selling and so on.

Underwriting:

Underwriting entails an agreement whereby a person/organization agrees to take a specified number of shares or debentures or a specified amount of stock offered to the public in the event of the public not subscribing to it, in consideration of a commission – the underwriting commission. If the issue is fully subscribed by the public, there is no liability attaching to the underwriters; else they have to come forth to meet the shortfall to the extent of the under-subscription. The underwriters in India may broadly be classified into the following two types:

- ✓ Institutional Underwriters
- ✓ Non Institutional underwriting.

The public financial institutions namely IDBI, IFCI, ICCI, LIC and UTI, underwrite a portion of the issued capital. Usually, the underwriting is done in addition to granting term finance by way of loans on debentures.

Distribution:

The sale of securities to the ultimate investors is referred to as distribution; it is another specialized job, which can be performed by brokers and dealers in securities who maintain regular and direct contact with ultimate investors.

8. Explain the regulations of primary market.

- ✓ **Disclosure of All Material Facts is made Compulsory**: SEBI has made it compulsory for companies do disclose all the facts and risk factors regarding the projects undertaken by the company. The basis on which the premium amount is calculated should also be disclosed by the company as per SEBI norms. SEBI also advises the code of ethics for advertising in media regarding the public issue.

- ✓ **Encouragement to Initial Public Offers**: In order to encourage Initial Public Offers (IPO) in the primary market, SEBI has permitted companies to determine the par value of shares issued by them. SEBI has allowed issues of IPOs to go for "Book Building" – i.e. reserve and allot shares to individual investors. But the issuer will have to disclose the price, the issue size and the number of securities to be offered to the public.

- ✓ **Increase of Popularity to Private Placement Market**: In recent years, private placement market has become popular with issuers because of stringent entry and disclosure norms for public issues. Besides low cost of issuance, ease of structuring investments and saving of time lag in issuance are the other causes responsible for the rapid growth of private placement market.

- ✓ **Underwriting has made Optional**: To reduce the cost of issue in primary market, SEBI has made underwriting of issue optional. However, the condition that if an issue was not underwritten and was not able to collect 90% of the amount offered to the public, the entire amount collected would be refunded to the investor is still in force.

- ✓ **Issue of Due Diligence Certificate**: The lead managers have to issue due diligence certificate, which has now been made part of the offer document.

- ✓ **Conditions regarding Application Size etc.**: SEBI has raised the minimum application size and also the proportion of each issue allowed for firm allotment to institutions such as mutual funds.

- ✓ **Regulation of Merchant Banking**: SEBI has brought Merchant banking under its regulatory framework. The merchant bankers are now to be authorized by SEBI. Merchant bankers, now have a greater degree of accountability in the offer document and issue process.

- ✓ **Imposition of Compulsory Deposit on Companies making Public Issues**: In order to induce companies to exercise greater care and diligence for timely action in matters relating to the public issues of capital, SEBI has advised stock exchanges to collect from companies making public issues, a deposit of one per cent of the issue amount which could be forfeited in case of non-compliance of the provisions of the listing agreement and, non-dispatch of refund orders and share certificates by registered post within the prescribed time.

- ✓ **Reforms as to Mutual Funds**: The Government has now permitted the setting up of private mutual funds and a few have already been set up. UTI has now been brought under the regulatory jurisdiction of SEBI. All mutual funds are allowed to apply for firm allotments in public issues. To improve the scope of investments by mutual funds, the latter are permitted to underwrite public issues. Further, SEBI has relaxed the guidelines for investment in money market instruments. Finally, SEBI has issued fresh guidelines for advertising by mutual funds.

- ✓ **Vetting of Offer Document**: SEBI vets offer documents to make sure that the company listing the shares has made all disclosures in it. All the guidelines and regulatory measures of capital issues are meant to promote healthy and efficient functioning of the issue market (or the primary market).

UNIT III SECONDARY MARKET

Stock exchanges in India - History and development -listing - Depositaries - Stock exchange mechanism: Trading, Settlement, risk management, Basics of pricing mechanism - Player and stock exchange - Regulations of stock exchanges –Role of SEBI – BSE, OTCEI, NSE, ISE, - Role of FIIs, MFs and investment bankers –Stock market indices – calculation.

PART – A

1. Define secondary market.

   The secondary market is a market in which existing securities are resold or traded. This market is also known as the stock market. In India the secondary market consists of recognized stock exchanges operating under rules, by-laws and regulations duly approved by the government.

2. List the functions of secondary market.

   - ✓ To facilitate liquidity and marketability of the outstanding equity and debt instruments.
   - ✓ To ensure a measure of safety and fair dealing to protect investors' interests.

3. List the stock exchanges in India.

   - ✓ Regional stock exchanges
   - ✓ The National Stock Exchanges (BSE and NSE)
   - ✓ The Over the Counter Exchange of India (OTCEI)
   - ✓ The Inter-Connected Stock Exchange of India (ISE)

4. Explain the two mediums of trading in secondary market.

   - ✓ Over the Counter (OTC) Market - OTC Markets are the informal type of market where the trades are negotiated and securities are traded and settled bilaterally over the counter.
   - ✓ Another option is trading through the stock exchanges where buyers and sellers do not know each other. The settlement of trade done as per the fixed time schedule and trades executed on the stock exchange are settled through the clearing corporation, who acts as a counterparty and guarantees settlement.

5. Define regional stock exchange.

   A regional stock exchange is a stock exchange that is located in a region outside that country's primary financial center. Often, companies who cannot meet the strict listing requirements of a national exchange may qualify for a listing on a regional exchange, though a company that qualifies to be on a national exchange may also register for a listing on one or more regional exchanges.

6. What is BSE?

   Bombay Stock Exchange (BSE): BSE is the oldest stock exchange of Asia. The extensiveness of the indigenous equity broking industry in India led to the formation of the Native Share Brokers Association in 1875, which later became Bombay Stock Exchange Limited (BSE). BSE is widely recognized due to its important and pre-eminent role in the growth of the Indian capital market.

7. What is NSE?

   National Stock Exchange (NSE): With the liberalization of the Indian economy, it was found inevitable to lift the Indian Stock market trading system on part with the internationalstandards. On the basis of the recommendations of high powered Pherwani Committee, the National Stock Exchange was incorporated in 1992.

8. Define OTCEI.

   Over the Counter Exchange of India (OTCEI): The traditional trading mechanism prevailedin the Indian stock markets gave way to many functional inefficiencies such as absence of liquidity, lack of transparency, unduly long settlement periods and benami transactions,which affected the small investors to a great extent.

9. Define demutualization of stock exchange.

   Demutualization refers to transition process of an exchange from a 'member-owned organization' to a 'shareholder-owned company. In other words, it is the transformation ofthe legal structure of the exchange from a mutual form to business corporation form and so termed as demutualization. After demutualization the ownership, the management, and the trading rights at the exchange are segregated from one another.

10. Discuss the role of stock exchanges in India.

    - ✓ Raising Capital for Businesses
    - ✓ Facilitating Company growth
    - ✓ Creating Investment opportunities for small investors
    - ✓ Barometer of the Economy
    - ✓ Speculation

11. What is meant by listing?

    - ✓ A company who wants its securities to be traded on the floor of a stock exchange must list its securities on an exchange. A company can get its securities listed on more than one stock exchange. Earlier it was compulsory for the companies to list on the regional stock exchange that is nearest to its registered office, but now it is not mandatory.
    - ✓ A security listed on one exchange is permitted for trading on the other exchange.

12. Why listing of securities is essential?

    The listing of securities is essential as it provides:

    - ✓ Ready marketability and makes securities more liquid and transferable.
    - ✓ Ensure proper supervision and control over the securities dealings.
    - ✓ Protect the interest of the investors and general investing public.

13. Discuss the listing requirements.

    - ✓ The Memorandum and Articles of Association must not contain any provisions that restrict free transfer of shares.
    - ✓ The company must offer for public at least 25 percent of its issued capital.
    - ✓ The minimum issued capital of the company should be at least Rs. 10 crores in case ofBSE and Rs.5 crores in case of other exchanges.
    - ✓ Application should be invited in denomination of market units of trading.
    - ✓ No previous track record is necessary.

14. Define delisting of securities.

    In case the companies fail to comply with the requirements an exchange can take disciplinary actions as such of suspension/ delisting of thesecurities. Delisting means removal of securities of a listed company from the stock exchangewhere it was registered.

15. What is depositories?

    A depository is an organization which holds securities (shares, bonds, government securities, mutual funds units etc.) of various investors in electronic form at the request of theinvestors through the registered Depository Participant. It also provides services related to transactions (transfer of ownership) in securities.

16. What is depositories participants?

    A Depository Participant (DP) is an agent of the depository through which it deals with the investors and provides depository services. Public financial institutions, scheduled commercial banks, foreign banks operating in India with the approval of the Reserve Bank of India, state financial corporations, custodians, stock-brokers, clearing corporations/ clearing houses, NBFCs and Registrar to an issue.

17. Define Dematerialization.

    Dematerialization is the process through which securities in physical form are converted to electronic form and credited in to BO's account of investor by DP. In order to dematerialize the securities, the investor fills in a Dematerialize Request Form (DRF) and submits the physical securities that are to be dematerialized along with the DRF to DP. Separate DRF has to be filled for each ISIN.

18. Define stock exchange mechanism.

    A stock exchange is an organized market, where traders can buy and sell the stocks of different companies. In Stock Market, Investors and traders connect to the exchanges via their brokers, and place buy or sell orders on these exchanges.

19. Explain trading and settlement procedure.

    The trading and settlement process in a secondary market begins with the selection of a broker or sub-broker and ends with settlement of shares. For secondary-market trading, you need first to open a dematerialized (DEMAT) account with a broking house or bank. Once your account is active, you can buy or sell securities. Once your order is executed, and you get a contract note, that's when your trade is settled.

20. What is trade settlement?

    Trade settlement is a two-way process which comes in the final stage of the transaction. Once the buyer receives the securities and the seller gets the payment for the same, the trade is said to be settled. While the official deal happens on the transaction date, the settlement date is when the final ownership is transferred. The transaction date never changes and is represented with the letter 'T'. The final settlement does not necessarily occur on the same day. The settlement day is generally T+2.

21. List the types of settlements in the stock market.

    Trade settlements in the stock market have been broadly categorized into two:

    - ✓ Spot settlement – This is when the settlement is done immediately following the rolling settlement principle of T+2.
    - ✓ Forward settlement – This happens when you agree to settle the trade at a future date which could be T+5 or T+7.

22. What is rolling settlement?

    A rolling settlement is one in which the settlement is made in the successive days of the trade. In a rolling settlement, trades are settled in T+2 days, which means deals are settled by the second working day. This excludes Saturday and Sunday, bank holidays and exchange holidays. So, if a trade is conducted on a Wednesday, it will be settled by Friday. Similarly, if you buy a stock on Friday, the broker immediately deducts the total cost of investment from your account the same day, but you receive the shares on Tuesday. The settlement day is also the day you become the shareholder of record.

23. List the rolling settlement rules in BSE.

    - ✓ In the Bombay Stock Exchange (BSE), securities in the equity segment are all settled in T+2 days.
    - ✓ Government securities and fixed income securities for retail investors are also settled in T+2 days.
    - ✓ Pay-in and pay-out of monies and securities need to be completed on the same day.

- ✓ The delivery of securities and payment by the client has to be done within one working day after the BSE completes the pay-out of the funds and securities.

24. What is pay-in and pay-out:

Pay-in is the day when the buyer sends the funds to the stock exchange, and the seller sends the securities. Pay-out is the day when the stock exchange delivers the funds to the seller, and the shares purchased to the buyer.

25. What is risk management?

In simple terms, risk management is a method through which investors identify, measure and analyze risk for various trading decisions, before choosing to accept or to mitigate it. Every time an investor assesses the risk involved in different investments before making a choice, risk management takes place.

26. List the features of stock exchanges.

- ✓ Capital Formation
- ✓ Facilitate Trading
- ✓ To inculcate habit of saving
- ✓ To raise financial awareness
- ✓ To present information
- ✓ To protect investors from frauds
- ✓ To form a link between an investor and borrower
- ✓ To provide access
- ✓ To develop economy

27. List the important functions of stock exchange.

- ✓ Act as Economic Barometer
- ✓ Mobilization of savings and capital formation
- ✓ Contribution to economic growth
- ✓ Pricing of securities
- ✓ Safety of transactions
- ✓ Spreading of equity cult
- ✓ Providing scope for speculation

- ✓ Better allocation of capital
- ✓ Promoting the habit of savings and investment
- ✓ Providing liquidity and marketability to existing securities

28. Define SEBI.

In India trading of securities and the operations of the stock exchanges are governed by the provisions of the Securities Contracts (Regulation) Act, 1956. While the capital marketincluding the market for equity and debt securities is regulated by SEBI. It was established under the Securities and Exchange Board of India Act, 1992 as a regulatory authority for the capital markets in India. SEBI has good full autonomy and authority to regulate and develop the capital market.

29. List the objectives of SEBI.

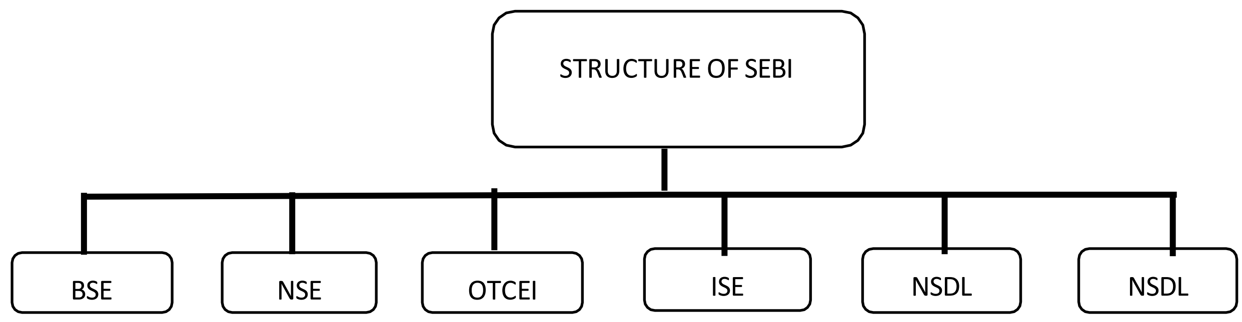
The four important objectives which this acts make SEBI serve are, Protection, Development, Regulation and Supervision:

- ✓ Protection of the interest of the investors in securities.
- ✓ Development of the securities market
- ✓ Regulation of the securities market
- ✓ Supervision of securities market

30. List the major functions of SEBI.

- ✓ Control & regulation of stock exchanges and stock brokers
- ✓ Regulation of merchant bankers, mutual funds, and other players in the market
- ✓ Development of stock & capital markets in the right direction
- ✓ Licensing & settlement of brokers, sub-brokers and other intermediaries in the capital market
- ✓ To ensure investors' protection

31. Draw the structure of SEBI.



32. What are the depository system available in India?

    Depository system is an organization where the financial securities are held in dematerialized form in the same way as a bank holds money. There are two depositories in India. They are NSDL (National Securities Depository Limited). CSDL (Central Services Depository India Limited).

33. Define Stock market index.

    A stock market index is created by selecting a group of stocks that are capable of representing the whole market or a specified sector or segment of the market. A stock market index acts as the indicator of the overall economy or economy of a sector.

    Types of indices:

    - ✓ NIFTY
    - ✓ SENSEX

34. Discuss the Role of FIIs and MFs.

    FIIs directly impact the stock/securities market of the country, its exchange rate and inflation. FIIs can invest in listed, unlisted, and to-be-listed companies on the stock markets, in both the primary and secondary markets.

    Mutual funds play an important ROLE in promoting a healthy capital market. They provide active support to secondary market and increase liquidity of capital market and bring stability in financial market.

35. What are the roles played by investment bankers?

    - ✓ Capital Raising. Book Building. Prospectus Drafting.
    - ✓ Private Placement of Capital.
    - ✓ Mergers, Acquisitions & Divestitures.
    - ✓ Corporate Restructuring.
    - ✓ Debt & Equity Advisory Services.
    - ✓ Bond Issuance & Pricing on Bond Markets.
    - ✓ Hedge Fund, Mutual Fund, & Pension Fund Advisory Services.

PART – B

1. Explain briefly about stock exchanges in India and its functions.

Stock Exchange in India

Indian stock exchange is one of the oldest markets in Asia and is a yardstick to measure the health and progress of the economy of the country. Over the course of the period, the market has transitioned into the electronic market and securities are dealt in dematerialization form.

There are two major stock exchanges in India- National Stock Exchange of India (NSE) and Bombay Stock Exchange (BSE). National Stock Exchange was established in Mumbai in 1992 and started trading in 1994. Bombay Stock Exchange was established in 1875 in Mumbai.

Other stock exchanges are as follows-

- ✓ Calcutta Stock Exchange in Kolkata
- ✓ India International Exchange
- ✓ Metropolitan Stock Exchange

Market Indices

There are two major indices in the stock exchange of India – Sensex and Nifty. Sensex comprises of the weighted average of the market capitalization of stock of 30 well established and financially sound companies across different key sectors in India. Nifty comprises of top 50 companies in 12 sectors of the Indian economy in one portfolio. It reflects the health of the Indian economy from a broader perspective.

SENSEX is an indicator of Bombay Stock Exchange and NIFTY is an indicator of National Stock Exchange of India.

Trading Hours and Settlement on Stock Exchange of India

Trading in the stock market in India takes place in between 9:55 AM to 3:30 PM Indian Standard Time, Monday to Friday.

Settlement of securities takes places in T+2 period. It means if the transaction has happened on Tuesday, it will be settled on Thursday.

Functions of Stock Exchange in India

The important functions of the stock exchange are as follows:

- ✓ Act as Economic Barometer: The stock exchange is the mirror which reflects the economic condition of a country. Major changes in the economy of a country due to social, political, economic or climate reasons reflect in the share prices. The rise or fall in stock prices indicates the boom, recession or depression cycles of the economy. The stock exchange act as an economic barometer which reflects the economic and business condition in a country.

- ✓ Mobilization of savings and capital formation: Stock exchange forms a link between the investors and borrowers. The fund surplus entities invest their money in the stock market. The fund deficit units or borrowers raise capital through securities. So the stock exchange performs the function of linking the investors and fund deficit entities and facilitates the mobilization of savings and capital formation.

- ✓ Contribution to economic growth: In stock exchange, financial securities are traded. The securities are bought and sold. This process of disinvestment and reinvestment helps in capital formation. The funds generated by the companies can be used in productive activities which can increase the industrial production and thus help in economic growth.

- ✓ Pricing of securities: The stock market helps in the valuation of securities on the basis of their demand and supply. There is more demand for the securities of profitable and growth oriented companies and they are valued higher. This valuation of securities is not only useful for investors but also for government and creditors. The investors can know the value of their investment, the creditors can value the creditworthiness and government can impose taxes on value of securities

- ✓ Safety of transactions: Companies get listed on stock exchange only after the verification of the all their credentials and after getting listed, they have to abide by all the rules and regulations. This procedure ensures safety of transactions when trading on stock exchange.

- ✓ Spreading of equity cult: Spreading equity cult means making people aware about investment and encouraging them to invest in ownership securities by regulating new issues and better trading practices. Stock exchange educates people on investment and encourages them to invest in wider ownership securities.

- ✓ Providing scope for speculation: Speculation is purchasing of financial securities solely with a purpose of gaining profit through price movement to a target price. Stock exchange provides a restricted and controlled scope for speculation.

- ✓ Better allocation of capital: The stock market transactions result in funds flow from the less profitable to more profitable enterprises. The share prices of the profit making companies are generally high and these shares are actively traded on the exchange which helps these companies to raise new capital easily and grow their business. It also helps investors in getting better returns by allocating their funds to profitable channels.

- ✓ Promoting the habit of savings and investment: With proper market studies and financial awareness, investors can earn good profits on their investment in securities. This can promote habit of savings and investment in them which will infuse more funds in to the stock market.

- ✓ Providing liquidity and marketability to existing securities: Stock exchange is a ready and continuous market for trading i.e. buying and selling of securities. It provides a platform where buyers and sellers can buy and sell the securities. The investors can invest in long-term as well as short term securities. They can easily convert their investments into cash if needed by selling those securities

How to Deal in Stock Exchanges in India

In order to deal in stock exchange in India, one must have a Demat A/c. It is just like a bank account. Various banks in India provide this facility. Through Demat A/c, an investor can buy or sell securities in trading hours.

Regulation of Stock Exchange in India

Entire stock exchange of India is regulated by the Securities and Exchange Board of India (SEBI) which was established in 1992 as an independent authority. SEBI has the power to impose fines and penalties in case of violation of rules and regulations. It plays a pivotal role and protects the interest of investors in the stock exchange of India. SEBI promotes education and training of intermediaries of the stock market.

Bull Market and Bear Market

A bull market is a market where buyers are aggressively buying the shares in an expectation that shares price will rise and will sell at later date. A bear market is a market where prices are falling.

Strong economic conditions, high employment levels, the favorable government are few factors which lead to a bull market whereas poor economic conditions, natural adversity, unemployment or sudden unfavorable political changes lead to bear market.

2. Briefly explain the history and development of stock exchanges in India.

The stock exchange or market is a place where stocks, shares and other long-term commitments or investment are bought and sold.

The economic significance of a stock market results from the increased marketability resulting from a stock exchange share quotation. The stock exchange is an essential institution for the existence of the capitalist system of the economy and for the smooth functioning of the corporate form of organisation.

The Securities Contracts (Regulation) Act of 1-956 defines, a stock exchange as "an association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling, business in buying, selling and dealing in securities."

Stock Exchanges are noted as "an essential concomitant of the Capitalistic System of economy. It is indispensable for the proper functioning of corporate enterprise. It brings together large amounts of capital necessary for the economic progress of a country. It is a citadel of capital and pivot of money market. It provides necessary mobility to capital and indirect the flow of capital into profitable and successful enterprises. It is the barometer of general economic progress in a country and exerts a powerful and significant influence as a depressant or stimulant of business activity."

History of Stock Exchange in India:

The first organised stock exchange in India was started in 1875 at Bombay and it is stated to be the oldest in Asia. In 1894 the Ahmedabad Stock Exchange was started to facilitate dealings in the

shares of textile mills there. The Calcutta stock exchange was started in 1908 to provide a market for shares of plantations and jute mills.

Then the madras stock exchange was started in 1920. At present there are 24 stock exchanges in the country, 21 of them being regional ones with allotted areas. Two others set up in the reform era, viz., the National Stock Exchange (NSE) and Over the Counter Exchange of India (OICEI), have mandate to have nation-wise trading.

They are located at Ahmedabad, Vadodara, Bangalore, Bhubaneswar, Mumbai, Kolkata, Kochi, Coimbatore, Delhi, Guwahati, Hyderabad, Indore, Jaipur' Kanpur, Ludhiana, Chennai Mangalore, Meerut, Patna, Pune, Rajkot.

The Stock Exchanges are being administered by their governing boards and executive chiefs. Policies relating to their regulation and control are laid down by the Ministry of Finance. Government also Constituted Securities and Exchange Board of India (SEBI) in April 1988 for orderly development and regulation of securities industry and stock exchanges.

Recent developments in stock exchange:

- ✓ Insider Trading - Insider trading had become an extremely sensitive and controversial subject in the stock market in India.

  Any person in power whether an officer or director who had access to information of private matters of the company relating to expansion programs of the company, changes in policies, amalgamations, joint contracts, collaboration or any information about its financial results was making full use of his position to give an advantage to relatives, friends or known persons by leaking out information leading to frauds and rigging of price relating to securities.

  SEBI has laid down guidelines by prescribing norms handling information which may be considered sensitive. Price forecasts, changes in investment plans, knowledge of mergers and acquisitions, information about contracts are not to be disclosed. The staff and officers who have such sensitive information are to be identified in each company. Controls are to be made on the handling of sensitive information.

- ✓ Depository or Paperless Trading - The Depository Act was passed in 1996 allowing dematerializing of securities and transfer of security through electronic book entry to help in reducing settlement risks and infrastructure bottlenecks. The dematerialized securities will not have any identification numbers or distinctive numbers.

  The National Securities Depository Ltd., was set up in Nov. 1996. Trading of new Initial (NSDC) public offers was to be in dematerialized form upon listing. An exclusive feature of the Indian Capital Market is that multiple depository system has been encouraged.

- ✓ Conversion of Shares into Dematerialized Form - In order to dematerialize physical securities, an investor has to fill in a Demat Request Form (DRF) which is available with the DP and submit the same along with physical certificates DRF has to be filled for each ISIN no. The investor has to surrender certificates for dematerialization to the DP (depository participant). Depository participant intimates Depository of the request through the system.

He then submits the certificates to the registrar. The Registrar confirms the dematerialization request from depository. After dematerializing certificates, Registrar updates accounts and informs depository of the completion of dematerializations. Depository updates its accounts and informs the depository participant. Depository participant updates the account and informs the investor.

- ✓ Surveillance on Price Manipulation - SEBI introduced surveillance and enforcement measures against intermediaries' violation of laws especially in price manipulations. All exchanges have surveillance departments which co-ordinate with SEBI. SEBI has enforced information to be submitted by exchanges on daily settlement and monitoring reports. SEBI has also created a database for trading on National and Bombay Stock Exchanges.

  If price manipulation is detected, auction proceeds may be impounded or frozen so that the manipulator cannot use it. SEBI has introduced 'Stock Watch' an advances software for surveillance of market activities programmed to show movements from historical patterns through follow ups by analyst and trained investigators to act as a deterrent to trading and price rigging.

- ✓ Regulation of Stock Brokers - Stock Broker and Sub-Brokers Regulation Act, was passed in 1992. Brokers had to have a dual registration both with SEBI and with Stock Exchange. Penal action would be taken against any broker for violation of laws. Capital adequacy norms were introduced and they were 3% for individual brokers and 6% for corporate brokers.

  For investor protection measures, brokers have been disciplined by introducing the system of maintaining accounts for clients and brokers own account and disclosure of transaction price and brokerage separately in contract note.

- ✓ Forward Trading and Badla - Forward trading had been in practice in India as it was the main speculative activity in stock exchange. Futures and Options were absent in the Indian Market and Forward Trading was called Contracts for Clearing. This system enables a trader to play with price expectations, transfer outstanding buy or sell positions and delivery of securities.
- ✓ Options and Derivatives - Options can be classified as call options or put options. The National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) have launched derivatives. They will offer derivatives for three tenures one in the first instance each for subsequent three months.

  So in July, Nifty call and put options can be purchased for July end, August end and September end. The last day of the contract would be the expiration date. In an options contract, a premium has to be paid to enter a contract.

  Buyer's losses are limited to the extent of premium paid but his gains are unlimited. Seller's profits are limited to premiums received but losses are unlimited.

  These derivatives have been started by SEBI to bring about investor confidence to establish the market and to reduce risk. Initially, options trading will be allowed only in 14 stocks. Option will not allow a person to defer settlement of sale/purchase but they will enable placing of bets on Stock Markets.

- ✓ Regulation of Mutual Funds - SEBI regulates the Mutual Funds to provide portfolio disclosure and standardization of accounting procedures. It is a requirement of SEBI that Mutual Funds should have a trustee company which is separate from the asset Management Company and the securities of the various schemes should be kept with a custodian independent of the Mutual Fund.

  All Mutual Funds should be regulated with the SEBI. All schemes of UTI after 1994 have also been brought under the control of SEBI. SEBI created certain procedures of valuation norms and asset value and pricing for the Mutual Funds. The primary interest of SEBI to control Mutual Fund schemes was to protect investors from fraudulent deals.

- ✓ Regulation of Foreign Institutional Investors (FIIs) - FIIs had a large volume of funds. By the nature of their trading volumes, FIIs can retain Control over the stock market. SEBI had to keep these FIIs under its control for protecting the investors. Hence, all FIIs had to be registered with SEBI.

- ✓ Buy back of Shares - Buy Back of shares is another development of Indian Corporate practice. It was permitted by SEBI in 1998, following the companies (amendment) ordinance by the Central Government. Buy back of shares is a method whereby a company is allowed to purchase its own shares out of its free reserves, securities premium account, or the proceeds of other specified securities like preference shares.

  However, it cannot be made out of earlier issue of equity shares. Buy back of shares may be done from existing shareholders on a proportionate basis, through open market purchases and through company employees where securities are issued under stock option or sweat equity.

- ✓ Bombay on Line Trading (BOLT) System - The BOLT system provides systematic trading in a growing volume of business. In 1995, the average daily turnover was exceeding 30 crores as there were more than 750 scrips to cope with. This led to delays in transactions as physical movement of share transfers took a long time and in the absence of custodial services, the settlement periods kept on increasing.

  The BOLT system provides information on the best buy and sells rates for scripts, pending and executed orders, negotiated and crossed deals, market position of all the scrips of a broker, domestic share indices and market and economy related news.

3. Discuss the reforms in Indian stock market / steps taken by SEBI to protect theinvestors in the secondary market.

A financial market is a broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives

A capital market is one in which individuals and institutions trade financial securities.

Stock markets allow investors to buy and sell shares in publicly traded companies

Securities market is an economic institute within which takes place the sale and purchase transactions of securities between subjects of the economy, on the basis of demand and supply

Stock Exchange is an organized market place where securities are traded where the price is determined through the supply-demand mechanism. These securities are issued by the Government, semi-Government bodies, public sector undertakings and companies for borrowing funds and for raising resources.

Players in stock market

- ✓ Buyers and sellers
- ✓ Financial intermediaries
- ✓ Banking financial intermediaries
- ✓ Non-banking financial intermediaries – insurance companies, unit trusts and finance investment companies
- ✓ Brokers and dealers
- ✓ Individuals
- ✓ Institutions – registrars, lead managers, underwriters, share transfer agents, etc

Major reforms in Indian stock market:

The major reforms undertaken in stock market of India includes:

- ✓ Corporate Securities Market: With the objectives of improving market efficiency, enhancing transparency, preventing unfair trade practices and bringing the Indian market up to international standards, a package to develop the securities market was introduced.

  The issuers complying with the eligibility criteria were allowed freedom to issue the securities at market determined rates. The secondary market overcame the geographical barriers by moving to screen based trading. Trades enjoyed counter-party guarantee. The trading cycle shortened to a day and trades are settled within 2 working days, while all deferral products were banned. Physical security certificates almost disappeared. A varietyof derivative products were permitted.

- ✓ SEBI Act, 1992: It created a regulator (SEBI), empowered it adequately and assigned it withthe responsibility for (a) Protecting the interests of investors in securities, (b) Promotingthe development of the securities market, and (c) Regulating the securities market. Enactment of SEBI Act is the first attempt towards integrated regulation of the securities market.

- ✓ Creation of Market Regulator: Securities and Exchange Board of India (SEBI), the securities market regulator in India, was established under SEBI Act 1992, with the main objective and responsibility for Protecting the interests of investors in securities, Promoting the development of the securities market, and Regulating the securities market.

- ✓ Screen Based Trading: Prior to setting up of NSE, the trading on stock exchanges in India was based on an open outcry system. The system was inefficient and time consuming because of its inability to provide immediate matching or recording of trades. In order to provide efficiency,

liquidity and transparency, NSE introduced a nation-wide on-line fully automated screen based trading system (SBTS) on the CM segment on November 3, 1994.

- ✓ Reduction of Trading Cycle: Earlier, the trading cycle for stocks, based on type of securities, used to vary between 14 days to 30 days and the settlement involved another fortnight. The Exchanges, however, continued to have different weekly trading cycles, whichenabled shifting of positions from one Exchange to another. It was made mandatory for all Exchanges to follow a uniform weekly trading cycle in respect of scrips not under rolling settlement. In December 2001, all scrips were moved to rolling settlement and the settlement period was reduced progressively from T+5 to T+3 days. From April 2003 onwards, T+2 day settlement cycle is being followed.

- ✓ Equity Derivatives Trading: In order to assist market participants in managing risks better through hedging, speculation and arbitrage, SC(R) A was amended in 1995 to lift the ban on options in securities. Trading in derivatives, however, took off in 2000 with index futuresafter suitable legal and regulatory framework was put in place. The market presently offers index futures, index options, single stock futures and single stock options.

- ✓ Short Selling: Short selling is defined as selling a stock which the seller does not own at thetime of trade. Pursuant to the recommendations of the Secondary Market Advisory Committee (SMAC) of SEBI and the decision of the SEBI Board, it was decided to permit all classes of investors to short sell. It increases liquidity in the market, and makes price discovery more efficient

- ✓ Cross Margining: Many trading members undertake transactions on both the cash and derivative segments of an Exchange. They keep separate deposits with the exchange for taking positions in two different segments. In order to improve the efficiency of the use of the margin capital by market participants and as in initial step towards cross margining across cash and derivatives markets SEBI allowed Cross Margining benefit in May 2008.

- ✓ Market Infrastructure: As part of the ongoing efforts to build debt market infrastructure,two new systems, the Negotiated Dealing System (NDS) and the Clearing Corporation ofIndia Limited (CCIL) commenced operations on February 15, 2002. NDS facilitates screen based negotiated dealing for secondary market transactions in government securities and money market instruments, online reporting of transactions in the instruments available on the NDS and dissemination of trade information to the market.

- ✓ Research in Securities Market: In order to deepen the understanding and knowledge about Indian capital market, and to assist in policy-making, SEBI has been promoting high quality research in capital market. It has set up an in-house research department, which brings out working papers on a regular basis. In collaboration with NCAER, SEBI brought outa 'Survey of Indian Investors', which estimates investor population in India and their investment preferences.

- ✓ Testing and Certification: A testing and certification mechanism that has become extremely popular and is sought after by the candidates as well as employers is unique on- line testing and certification programme called National Stock Exchange's Certification in Financial Markets (NCFM). It is an on-line fully automated nation-wide testing and certification system where the entire process from generation of question paper, testing, assessing, scores reporting and

certifying is fully automated - there is absolutely no scope forhuman intervention. It allows tremendous flexibility in terms of testing centers, dates and timing and provides easy accessibility and convenience to candidates as he can be tested at any time and from any location

- ✓ Demutualization: Historically, stock exchanges were owned, controlled and managed by the brokers. In case of disputes, integrity of the stock exchange suffered. NSE, however, was set up with a pure demutualized governance structure, having ownership, management and trading with three different sets of people. Currently, all the stock exchanges in India have a demutualized set up.

- ✓ Dematerialization: As discussed before, the old settlement system was inefficient due to the time lag for settlement and (ii) the physical movement of paper-based securities. To obviate these problems, the Depositories Act, 1996 was passed to provide for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed and accuracy. There are two depositories in India, viz. NSDL and CDSL. They have been set up to provide instantaneous electronic transfer of securities.

- ✓ Clearing Corporation: The anonymous electronic order book ushered in by the NSE did not permit members to assess credit risk of the counter-party and thus necessitated some innovation in this area. To address this concern, NSE had set up the first clearing corporation, viz. National Securities Clearing Corporation Ltd. (NSCCL), which commenced its operations in April 1996.

- ✓ Investor Protection: In order to protect the interest of the investors and promote awareness, the Central Government (Ministry of Corporate Affairs 1) established the Investor Education and Protection Fund (IEPF) in October 2001. With the similar objectives, the Exchanges and SEBI also maintain investor protection funds to take care of investor claims. SEBI and the stock exchanges have also set up investor grievance / service cells for redress of investor grievance. All these agencies and investor associations also organised investor education and awareness programmes.

- ✓ Globalization: Indian companies have been permitted to raise resources overseas through issue of ADRs, GDRs, FCCBs and ECBs. Further, FIIs have been permitted to invest in all types of securities, including government securities and tap the domestic market.

- ✓ Launch of India VIX 2: Volatility index is a measure of market's expectation of volatility over the near term. It measures the amount by which an underlying Index is expected to fluctuate in the near term, based on the order book of the underlying index options. India's first volatility index, India VIX (based on the Nifty 50 Index Option prices) was launched by NSE in April 2008.

- ✓ Direct Market Access: In April 2008, SEBI allowed the direct market access (DMA) facility to the institutional investors. DMA allows brokers to offer their respective clients, direct access to the Exchange trading system through the broker's infrastructure without manual intervention by the broker.

- ✓ Launch of Securities Lending & Borrowing Scheme: In April 2008, the Securities Lending & Borrowing mechanism was allowed. It allows market participants to take short positions effectively with less cost.

- ✓ Launch of Currency Futures: On August 29, 2008, NSE launched trading in currency future contracts in the USD-INR pair for the first time in India. Trading in other currency pairslike Euro – INR, Pound Sterling – INR and Japanese Yen was further made available for trading in March 2010.

- ✓ Launch of Interest Rate Futures: On August 31, 2009, futures on interest rate were launched on the National Stock Exchange.

- ✓ ASBA: Application Supported by Blocked Amount (ASBA) is a major primary market reform. It enables investors to apply for IPOs / FPOs and rights issues without making a payment. Instead, the amount is blocked in investors' own account and only an amount proportionates to the shares allotted goes out when allotment is finalized.

- ✓ Issue of Capital and Disclosure Requirements (ICDR) Regulations 2009: In August 2009, the SEBI issued Issue of Capital and Disclosure Requirements (ICDR) Regulations 2009, replacing the Disclosure and Investor Protection (DIP) Guidelines 2000. ICDR Regulations 2009 would govern all disclosure norms regarding issue of.

4. Explain the Structure of SEBI.

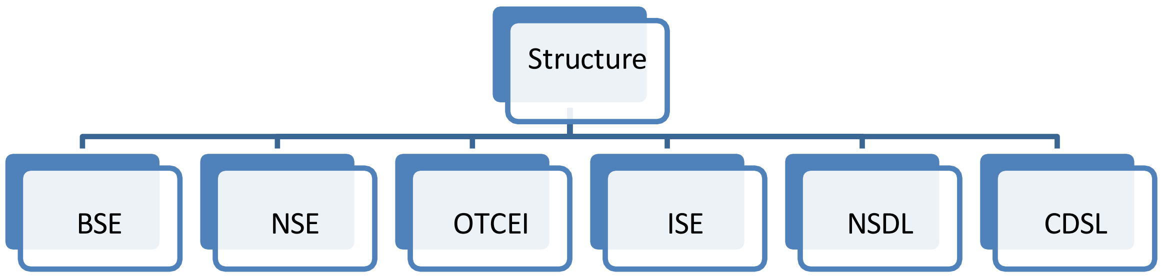
SEBI was framed in the year 1992. The Act is called as SEBI Act 1992.Securities and Exchange Board of India.

The present chairman of SEBI is Mr. Ajay Tyagi

Functions of SEBI

- ✓ Control & regulation of stock exchanges and stock brokers
- ✓ Regulation of merchant bankers, mutual funds, and other players in the market
- ✓ Development of stock & capital markets in the right direction
- ✓ Licensing & settlement of brokers, sub-brokers and other intermediaries in the capitalmarket
- ✓ To ensure investors' protection

Structure of SEBI



Bombay Stock Exchange.

- ✓ SENSEX is the index of Bombay Stock Exchange.
- ✓ Sensex represents Sensitivity Index.
- ✓ It was started in 1986.
- ✓ It composed of 30 stocks representing a large, well established and financially soundcompanies selected from different industry groups.
- ✓ Base year of BSE is 1978-79.
- ✓ Its base value is 100.
- ✓ Oldest Stock Exchange, Started in the year 1875

Objectives of BSE.

- ✓ To safeguard the interest of investing public having dealings on the exchange
- ✓ To establish & promote honorable and just practices in securities transaction
- ✓ To promote, develop and maintain well-regulated market for dealing in securities
- ✓ To promote industrial developments in the country through efficient resource mobilizationby the way of investment in corporate securities

National Stock Exchange

NIFTY is the index of National Stock Exchange

- ✓ It comprises of 50 stocks
- ✓ Its base value is 1000
- ✓ Started in the year 1992. By the recommendation of Pherwani Committee.

Objectives of NSE.

- ✓ To establish a nationwide trading facility for equities, debt instruments and hybrids
- ✓ To ensure equal access to investors all over the country through appropriate communication networks
- ✓ To provide a fair, efficient and transparent securities market to investors using an electrical communication network
- ✓ To enable shorter settlement cycle and book entry settlement system
- ✓ To meet current international standards of securities market

OTCEI

- ✓ The OTC Exchange of India (OTCEI), also known as the Over-the-Counter Exchange of India,is based in Mumbai, Maharashtra.
- ✓ It is India's first exchange for small companies, as well as the first screen-based nationwidestock exchange in India.

Objectives of OTCEI

- ✓ With the objective of providing more efficient services to investors, the country's first electronic stock exchange which facilitates ring less, scrip less trading was set up in 1992 with the name OTCEI.
- ✓ Trading takes place through a network of computers of OTC dealers located at several places linked to a central OTC computer using telecommunication networks.
- ✓ It has an exclusive listing of companies i.e., it does not ordinarily list and trade in companies listed in any other stock exchanges

Interconnected Stock Exchanges ISE

The regional stock exchanges are connected together

Depository System in India

Depository system is an organization where the financial securities are held in dematerialized form in the same way as a bank holds money. There are two depositories in India. They are NSDL (National Securities Depository Limited). CSDL (Central Services Depository India Limited)

NSDL and CDSL

- ✓ NSDL is operated by some large institutions such as NSE, IDBI, UTI, etc, while the CDSL is operated by some solid institutions like as BSE, HDFC, BOI, BOB, etc.
- ✓ NSDL was founded in 1996 and CDSL was founded in 1999.
- ✓ NSDL is the first depository established in India, which ensures trading and settlement of securities in electronic form while CDSL is the second largest depository in India, which facilitated the book-entry transfer of securities.
- ✓ Account maintenance, dematerialization, settlement of trade, and re-materialization. inter-depository transfers, off-market transfers, pledge, lending, and hypothecation of securities are the basic services provided by NSDL. On another side in CDSL, they offer services to hold equity, debentures, bonds, commercial papers, government securities,certificates of deposit, mutual funds, etc.
- ✓ There are around 1.45 crores investors in NSDL and another side in CDSL there are around 1.06 crores investors.

5. Explain the Listing of securities:

Listing means admission of securities of an issuer to trading privileges on a stock exchange through a formal agreement. The prime objective of admission to dealings on the Exchangeis to provide liquidity and marketability to securities, as also to provide a mechanism for effective management of trading.

Objectives of Listing

- ✓ Provide liquidity to securities;
- ✓ Mobilize savings for economic development;
- ✓ Protect interest of investors by ensuring full disclosures

Benefits / merits of listing of securities

- ✓ Access to a widespread shareholder base
- ✓ The stock exchange puts forward companies a right of entry to a wide-ranging and mounting investor base, which contains both entity investors and plentiful local and international institutional investors.
- ✓ Price Detection
- ✓ A listing facilitates companies to ascertain a price for their shares.
- ✓ Low cost capital
- ✓ The primary gain of raising capital from the market is that it eschews a number of the intermediation expenses apparent in the other forms of capital raising. Consequently, the market endows companies with capital at a cheaper cost.

Qualifications needed for listing of securities

- ✓ Minimum issued capital
- ✓ Payment of excess application money
- ✓ Listing on multiple exchanges
- ✓ Number of shareholders
- ✓ Appointment of market maker
- ✓ Articles of association
- ✓ Cost of public issue
- ✓ Advertisement

- ✓ Minimum subscription
- ✓ Applying mode
- ✓ Public offer size

Listing Procedure / Formalities:

- ✓ Post issue paid up share capital

  For IPOs – Rs. 10 croresFor FPOs – Rs. 3 crores

- ✓ Minimum issue size – Rs. 10 crores
- ✓ Minimum market capitalization (post issue paid up no. of equity shares x issue price) – Rs 25 crores
- ✓ Prior permission from the stock exchanges to use their name in the prospectus.
- ✓ Submit letter of application to the concerned stock exchanges.
- ✓ The allotment of shares should be done within 30 days of closure of issue
- ✓ Apply to the stock exchange within 7 working days after the allotment of shares.
- ✓ Deposit 1% security
- ✓ Payment of listing fee for shares (separate for mutual funds, bonds)

Initial Listing Fee	Rs 20000Annual Listing Fee
Upto 5 crore	Rs .15000
5- 10 crore	Rs. 25000
10-20 crores	Rs. 40000
20-30 crores	Rs. 60000
30 – 100 crores	Rs. 70000 + Rs. 2500 for every 5 crore I from 30 crores
100 – 500 crores	Rs 125000 + Rs. 2500 for every 5 crore I from 100 crores
500 – 1000 crores	Rs 375000 + Rs. 2500 for every 5 crore I from 500 crores
Above 1000 crores	Rs 625000 + Rs. 2750 for every 5 crore I from 1000 crores

  Annual fee would be paid within April 30th every financial year.

- ✓ Service tax should also be paid.
- ✓ Listing agreement should be signed between the company and the stock exchanges.

- ✓ Cash management services and collection of listing fee should be done through a bank. For e.g.: HDFC Bank for BSE.

6. Discuss the Mechanics of share trading.

   Mechanics of share trading

The rules and procedures for buying and selling securities are the same in all the recognized stock exchanges in India. The procedures are listed below:

Purchase of Shares

Purchasing of shares can be divided into two parts, namely purchase of existing shares from the market and purchase of shares of companies issuing fresh shares.

Purchase of existing shares from the market

- ✓ Placing the order with the broke: In the case of purchasing shares of existing companies, the order must be placed with the broker. The broker will require certain sum of money as margin money to be given along with the order.

- ✓ Receipt of contract note: When the shares are purchased a contract note is sent to the client to the number, rate and date of purchase. Many brokers require their clients to paythe balance amount on receipt of contract.

- ✓ Intimation of delivery: When the broker receives the share certificate and transfer deed from the seller he intimates the client to take shares and make payment in case it has been made. In case of outstation clients broker will call for balance payment and then send the share certificates and transfer through registered post.

- ✓ Sending shares for transfer: The last stage is the transfer of shares in the name of the purchaser. The buyer signs in the transferee column of the transfer deeds. The transfer deed is filled up if not already done. Share transfer stamps have to be affixed on the back of the transfer deeds.

- ✓ Thus the share certificate and complete transfer deeds are now ready which are sent at the share transfer department of the company concerned. The share certificates are received duly transferred within three months.

Purchase of shares being issued by a company

- ✓ Filling application form with application money: The company issuing the shares circulates printed application forms on which the intending purchaser has to fill-in the details like Name, Address, Occupation, Age, Specimen signatures etc. Application money per share multiplied by the number of shares applied for has to be paid along with this application.

- ✓ Receipt of allotment letter/refund order: Depending on response the company announces an allotment procedure. If the share are allotted on investor’s application, he will receive the allotment letter otherwise a refund order of the amount applied for will be received. Some companies send share certificates with the allotment letter.

- ✓ Payment of allotment money and call money: In most companies the face value of the share is not asked for with application. The company fixes allotment money and call money per share which it asks the shareholders to pay at certain intervals decided by the board of directors of that company.

- ✓ Endorsement of payment on share certificate: In companies where share certificates are issued before call money on those shares is received, the company makes an endorsement on the share to show that how many calls have been paid by the shareholders.

Sale of shares

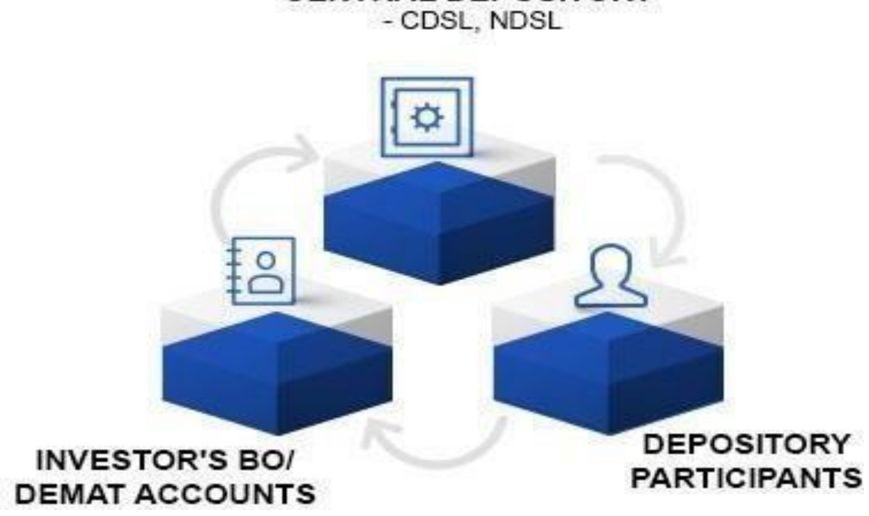
- ✓ Placing the order with the broker: The order of the sale of shares has to be placed with the broker, as an individual cannot sell or purchase shares at the stock exchange directly. Only members of that particular stock exchange can transact business at that stock exchange either for themselves or on behalf of their clients.

- ✓ Receipt of contract note: On the sale of shares the broker issues a Contract Note. A contract indicates the number of shares sold, the rate per share, the date of sale and the terms and conditions governing the sale. A contract note binds the broker and his client. In case the client is not satisfied he must notifyhis broker immediately on receipt of the contract.

- ✓ Delivery of share certificate(s) and transfer deed(s): The share certificates and transfer deeds have to be delivered by the broker to the broker of the same stock exchange, memberof another stock exchange or another of his clients, to whom he had sold the shares. The stock exchanges have fixed delivery days. On this day, the members deliver to each other the shares they have sold and purchased. The delivery day avoids the confusion that would arise if members could deliver on any day of their choice.

- ✓ Receipt of payment: Payment is made by the broker usually after 10 to 15 days from the day the shares have been sold and the share certificates along with valid transfers for the same are given to the broker. The payment is made according to the rate appearing on the contract as the rate is calculated after deducting the commission payable to the broker.

7. Explain the Trading and settlement procedure / trading system in stockexchanges.



DEMATERIALISATION

The process of converting securities held in physical form (certificates) to an equivalent number of securities in electronic form and crediting the same to the investor's demat account is called as 'Dematerialization'.

Securities in demat form (or electronic form) may again be converted back to the physical form, if desired, is called as 'Rematerialization'.

DEPOSITORIES:

A depository is compared to a bank. A depository holds securities for investors in electronic form and provides services related to transactions of securities. A depository interacts with clients through depository participants (DPs) which are organizations affiliated to a depository. An investor has to open a demat account with a DP to avail depository servicesof holding securities and transferring securities.

Depositories in India:

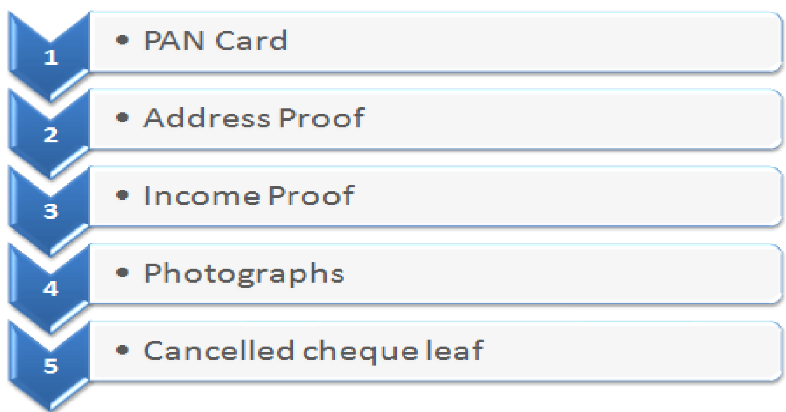
1. National Securities Depository Limited (NSDL)
2. Central Depositories Services (India) Limited (CDSL)

DEPOSITORY PARTICIPANTS:

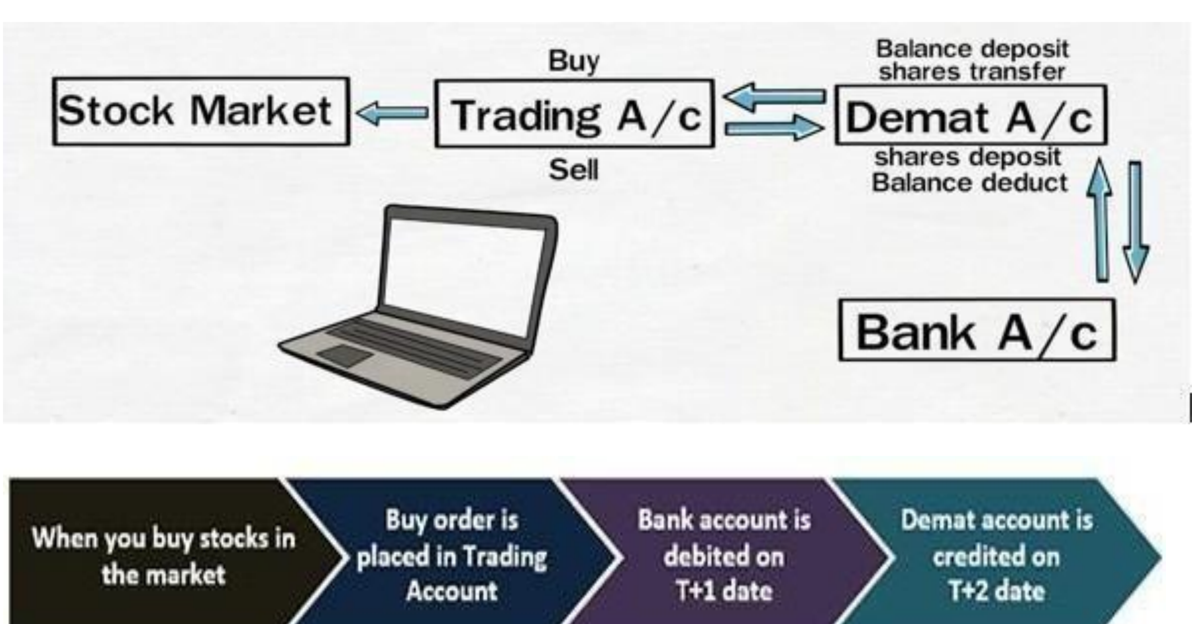
- ✓ India Infoline
- ✓ Karvy
- ✓ Geojit

BENEFICIARY OWNERS: - Beneficiary Owners are the clients in the Depository Participants.

REQUIREMENTS TO OPEN A DEMAT ACCOUNT



HOW DEMAT ACCOUNT WORKS:



PROCEDURE FOR TRADING

TRADING PROCEDURE OF SECURITIES

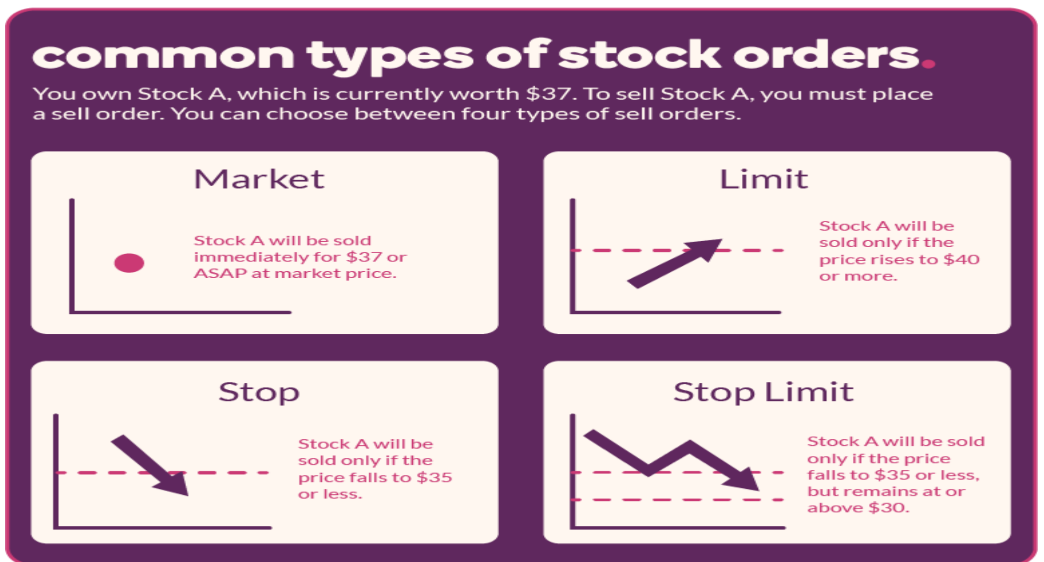
PRIMARY MARKET

Make an application to the company in the printed form as provided

SECONDARY MARKET

1. Opening demat account
2. Selection of broker
3. Getting Unique Client No.
4. Entering ISIN of Scrip
5. Placing of the order
6. Contract note
7. Settlement

TYPES OF ORDERS:



Market Order

A Market Order is an order to buy or sell a specified quantity of sharesimmediately, at the current market price.

Limit Order

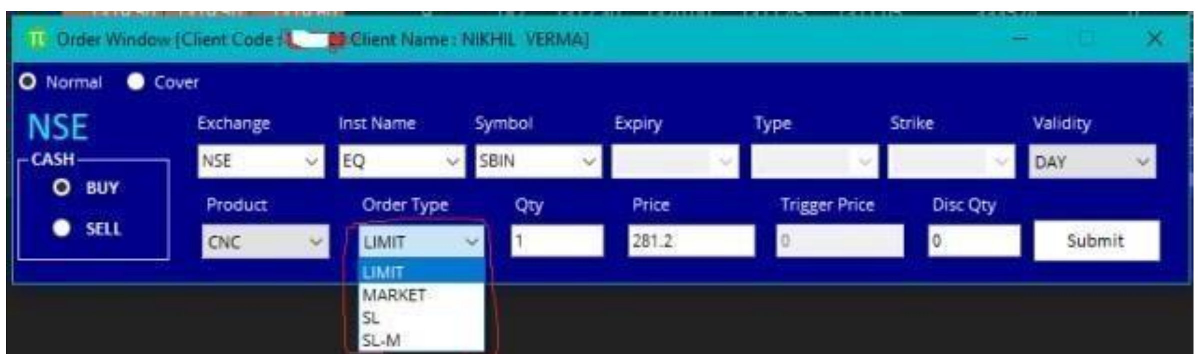
A Limit Order is an order type where a trader defines an exact price at which heis willing to buy or sell shares.

Stop Order

A Stop Order is an instruction to the stock broker to buy or sell stocks as soonas the stock price reaches the specified trigger price or stop price.

Stop Limit Order

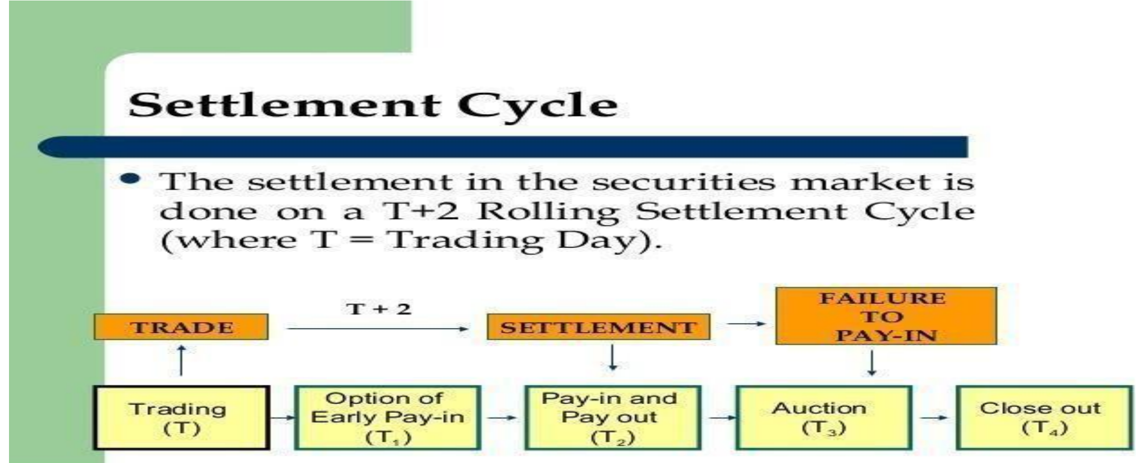
The stop limit order gives the investor the opportunity of specifying a limit price for executing the stop orders; the maximum price for a stop buy order and a minimum price for a stop sell order.



SETTLEMENT PROCEDURES OF SECURITIES. (Pay in and Pay out)

Compulsory rolling settlement

Under rolling settlements, the trades done on a particular day are settled after a given number of business days. A T+2 settlement cycle means that the final settlement of transactions done on T, i.e., trade day by exchange of monies and securities between the buyers and sellers respectively takes place on second business day (excluding Saturdays, Sundays, bank and Exchange trading



holidays) after the trade day.

8. What are the major indices and how it helps investors?

Stock market index:

A stock market index is created by selecting a group of stocks that are capable of representing the whole market or a specified sector or segment of the market. A stock market index acts as the indicator of the overall economy or economy of a sector.

Types of Indian Stock market indices:

Nifty

✓ It is the index of National Stock ExchangeIt comprises of 50 stocks

- ✓ Its base value is 1000

Other indices of NSE are;

  - ✓ S&P CNX Nifty
  - ✓ CNX Nifty Junior
  - ✓ S&P CNX 500
  - ✓ CNX Midcap 200
  - ✓ S&P CNX Defty
  - ✓ CNX IT
  - ✓ CNX Pharma
  - ✓ CNX FMCG
  - ✓ CNX Infrastructure, etc

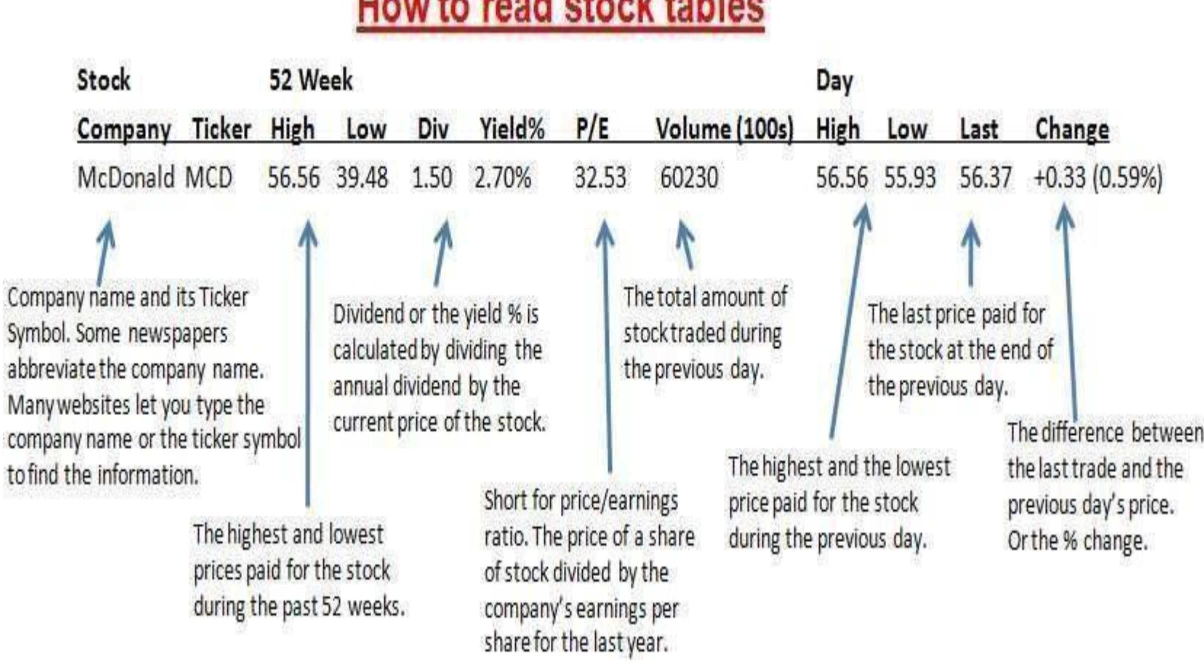
Sensex

- ✓ It is the index of Bombay Stock Exchange.Sensex represents Sensitivity Index.
- ✓ It was started in 1986.
- ✓ It composed of 30 stocks representing a large, well established and financially soundcompanies selected from different industry groups.
- ✓ Base year of BSE is 1978-79.Its base value is 100.
  - ✓ BSE – SENSEX
  - ✓ BSE Midcap
  - ✓ BSE Smallcap
  - ✓ BSE-100
  - ✓ BSE-200
  - ✓ Dollex 30
  - ✓ Dollex 200
  - ✓ BSE-PSU

- ✓ BSE-TECK, etc

Stock Market Quotations

Price quotations of traded securities are available from the stock exchanges and also being published in newspapers. Financial dailies give a detailed price quotation i.e., cl. Price, op. price, highest price, lowest price of the day, 2-week high and low price volumes of daily trading.



9. Discuss the SEBI guidelines in issue of shares, pricing and allotment of shares:

SEBI advises certain guidelines in issue of fresh share capital, first issue by new companies inPrimary Market and functioning of secondary markets in order to maintain quality standards.A few such guidelines and objectives of the Securities and Exchange Board of India (SEBI) are discussed here.

SEBI Guidelines for issue of fresh share capital

- ✓ All applications should be submitted to SEBI in the prescribed form.
- ✓ Applications should be accompanied by true copies of industrial license.
- ✓ Cost of the project should be furnished with scheme of finance.
- ✓ Company should have the shares issued to the public and listed in one or more recognizedstock exchanges.
- ✓ Where the issue of equity share capital involves offer for subscription by the public for the first

time, the value of equity capital, subscribed capital privately held by promoters, and their friends shall be not less than 15% of the total issued equity capital.

- ✓ An equity-preference ratio of 3:1 is allowed.
- ✓ Capital cost of the projects should be as per the standard set with a reasonable debt- equity ratio.
- ✓ New company cannot issue shares at a premium. The dividend on preference shares should be within the prescribed list.
- ✓ All the details of the underwriting agreement.
- ✓ Allotment of shares to NRIs is not allowed without the approval of RBI.
- ✓ Details of any firm allotment in favor of any financial institutions.
- ✓ Declaration by secretary or director of the company.

SEBI Guidelines for first issue by new companies in Primary Market:

- ✓ A new company which has not completed 12 months of commercial operations will not be allowed to issue shares at a premium.
- ✓ If an existing company with a 5-year track record of consistent profitability, is promoting anew company, then it is allowed to price its issue.
- ✓ A draft of the prospectus has to be given to the SEBI before public issue.
- ✓ The shares of the new companies have to be listed either with OTCEI or any other stock exchange.

SEBI guidelines for Secondary market

- ✓ All the companies entering the capital market should give a statement regarding fund utilization of previous issue.
- ✓ Brokers are to satisfy capital adequacy norms so that the member firms maintainadequate capital in relation to outstanding positions.
- ✓ The stock exchange authorities have to alter their bye-laws with regard to capitaladequacy norms.
- ✓ All the brokers should submit with SEBI their audited accounts.
- ✓ The brokers must also disclose clearly the transaction price of securities and thecommission earned by them. This will bring transparency and accountability for the brokers.

- ✓ The brokers should issue within 24 hours of the transaction contract notes to the clients.
- ✓ The brokers must clearly mention their accounts details of funds belonging to clients andthat of their own.
- ✓ Margin money on certain securities has to be paid by claims so that speculative investments are prevented.
- ✓ Market makers are introduced for certain scrips by which brokers become responsible forthe supply and demand of the securities and the price of the securities is maintained.
- ✓ A broker cannot underwrite more than 5% of the public issue.
- ✓ All transactions in the market must be reported within 24 hours to SEBI.
- ✓ The brokers of Bombay and Calcutta must have a capital adequacy of Rs. 5 lakhs and forDelhi and Ahmadabad it is Rs. 2 lakhs.
- ✓ Members who are brokers have to pay security deposit and this is fixed by SEBI.

PRICING OF SHARES

A share price is the price of a single share of a number of saleable equity shares of a company. In layman's terms, the stock price is the highest amount someone is willing to pay for the stock, or the lowest amount that it can be bought for.

- ✓ Issue of shares at par
- ✓ Issue of shares at premium
- ✓ Issue of shares a discount

10. Explain the Functions of stock exchanges

SEBI

SEBI was established to regulate the financial market of India. To achieve this objective, it takes care of three most important entities of financial market viz.

a) Issuers of securities

These are corporate entities which raise funds from the financial market. SEBI ensures that they get a transparent and healthy environment for their needs.

b) Investor

These are the ones who keep the financial market alive. They earn from these markets thusit is the responsibility of SEBI to ensure that investors don’t fall prey to any manipulation or fraud in

the market.

c) Financial Intermediaries

These intermediaries act as a mediator in the financial market. Their presence brings smoothness and safety in financial transactions.

SEBI FUNCTIONS

SEBI must "protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected there with or incidental there to."

Its functions can be divided in three parts viz.

I. Protective functions

SEBI performs the following functions to provide a safe and transparent environment for investors, who keep the financial market alive. These protective functions are –

- ✓ Stop manipulated huge fluctuations in the financial market which can cause huge lossfor investors/traders.
- ✓ Prohibit insider trading
- ✓ Provide Financial education for Investors
- ✓ Avoid manipulation of security markets by corporate.

II. Developmental functions

Developmental functions refer to the SEBI initiatives which bring fresh breath and innovations in Indian financial market. Developmental functions include

- ✓ Introduction of electronic platform for financial market
- ✓ DEMAT form of securities
- ✓ Introduction of Discount brokerage
- ✓ Training for financial intermediaries
- ✓ Buy-sell mutual funds directly from AMC through a broker
- ✓ Underwriting is optional to reduce the cost of issue
- ✓ IPO is permitted through exchange

III. Regulatory functions

Regulatory functions refer to enforcement of SEBI bye-laws to financial intermediaries and corporates. This ensures that stock market will run smoothly with transparency. This function includes –

- ✓ SEBI has designed guidelines and code of conduct that are enforced to financial intermediaries and corporates.
- ✓ SEBI registers all the intermediaries, share transfer agents, trustees and all those whoare associated with the stock exchange in any manner.
- ✓ SEBI registers and regulates the functioning of mutual funds.
- ✓ SEBI regulates takeover of companies.
- ✓ Conduct inquiries and audit of exchanges.

11. Discuss the risk management strategies in secondary market.

In stock market there is strong relationship between risk and return. Greater the risk, greater the return generally! In financial terminology risk management is the process of identifying and assessing the risk and then developing strategies to manage and minimize the same while maximizing the returns.

Every investment demands a certain amount of risk and for an investor to assume this risk he has to be compensated duly. This compensation is in the form of something called as the risk premium or simply the premium. Risk is therefore central to stock markets or investing because without risk there can be no gains. Successful investors use stock market risk management strategies to minimize the risk and maximize the gain.

In financial markets there are generally two types of risk; first the Market risk and second the Inflation risk.

- ✓ Market risk results from a possibility in increase or decrease of financial markets. The other risk i.e. the Inflation or the purchasing power risk results from rise and fall of prices of goods and services over time.
- ✓ The inflation risk is an important consideration in long term investments where as the market risk is more relevant in the short term. It is the market risk that can be managed and controlled to a certain extent, inflation risk cannot be controlled.

There are certain strategies that can be employed to mitigate the risk in a stock market. The strategies are as follows:

- ✓ Follow the trend of the market: This is one of the proven methods to minimize risks in a stock market. The problem is that, it is difficult to spot trends in the market and trends change very fast. A market trend may last a single day, a month or a year and again short term trends operate within long term trends.

- ✓ Portfolio Diversification: Another useful risk management strategy in the stock market is to diversify your risk by investing in a portfolio. In a portfolio you diversify your investment to several companies, sectors and asset classes. There is a probability that while the market value of a certain investment decreases that of the other may increase. Mutual Funds are yet another means to diversify the impact.
- ✓ Stop Loss: Stop loss or trailing tool is yet another device to check that you don't lose money should the stock go far a fall. In this strategy the investor has the option of making an exit if a certain stock falls below a certain specified limit. Self-discipline is yet another option employed by some investors to sell when the stock falls below a certain level or when there is a steep fall.

12. Explain the various roles played by FII's, MF's and investment bankers.

Introduction to Foreign Institutional Investors (FII)

Foreign Institutional Investors is an institutional, individual or group entity seeking to invest in the economy of a country other than where the entity is headquartered. FIIs are important to emerging economies because they bring funds and capital to businesses in developing countries.

Understanding Foreign Institutional Investors

These investors usually include hedge funds, mutual funds, insurance companies and investment banks among others. FIIs generally hold equity positions in foreign financial markets. Due to this, the companies invested in by FIIs generally have improved capital structures due to healthy inflow of funds. Thus, FIIs facilitate financial innovation and growth in capital markets.

The entry of an FII can cause a drastic swing in domestic financial markets. It increases demand for local currency and directs inflation. Therefore, there are restrictions put by the managing authority of a country on how much stake FIIs can hold in the domestic company. This ensures that the FII's influence on the company is limited, so as to avoid exploitation.

Factors to Consider

- ✓ Foreign Direct Investments (FDI) are a part of the investment made by Foreign Institutional Investors. However, not every FII will make an FDI in the country it is investing in.
- ✓ FIIs directly impact the stock/securities market of the country, its exchange rate and inflation.
- ✓ FIIs can invest in listed, unlisted, and to-be-listed companies on the stock markets, in both the primary and secondary markets.
- ✓ FDIs are more intentional, while FIIs are more concerned with transfer of funds and looking for capital gains in a prospective company.
- ✓ In India, FIIs tend to invest via Portfolio Investment Scheme (PIS) after registering with Securities

and Exchange Board of India (SEBI).

- ✓ Foreign Institutional Investors choose to invest in developing countries because they provide greater growth potential, due to the emerging economies.
- ✓ Sometimes, FIIs invest in the securities for a short period of time. This is helpful for liquidity in the market, but they also cause instability in flow of money.

Role of Mutual Funds in Indian Capital Market development

The Indian Mutual Fund segment is one of the fastest expanding segments of our Economy. During the last ten-year period the industry has grown at nearly 22 per cent CAGR. With assets of US $ 125 billion, India ranks 19th and one of the rapid growing countries of the world. The factors leading to the development of the industry are large market Potential, high savings rate, comprehensive regulatory framework, tax policies, innovations of new schemes, aggressive role of distributors, investor education awareness by SEBI, and past performance. Mutual funds are not only providing growth to capital market through channelization of savings of retail investors but themselves playing active role as active investor in Indian companies in secondary as well as primary market. Let's examine mutual funds role in capital market development in detail.

(1) Mutual fund as a source of household sector savings mobilization: Mutual fund industry has come a long way to assist the transfer of savings to the real sector of the economy. Total AUM of the mutual fund industry clocked a CAGR of 12.4 per cent over FY 07-16. That shows how mutual funds have played pivotal role in mobilizing retail investors' savings into capital market in last 10 years in India. By the end of March, 2017 AUM with Mutual funds are around Rs. 17.5 lakh crores. In 2017 itself, investors poured Rs. 3.4 lakh crores across all the categories of Mutual funds in India.

(2) Mutual Fund as Financial service or Intermediary: The financial services sector is the second-largest component after trade, hotels, transport and communication all combined together, and contributes around 15 per cent to India's GDP. With the rapid growth, mutual funds have become increasingly important suppliers of debt and equity funds. In fact, corporations with access to the low interest rates and increased share prices of the capital markets have benefited from the expansion in mutual fund assets. In recent years, mutual funds as a group have been the largest net purchaser of equities and a major purchaser of corporate bonds. All the MFs collect funds from both individual investors and corporate to invest in the financial assets of other companies.

(3) Mutual funds popularity among small investors: Small investors have lots of problems like limited funds, lack of expert advice, lack of access to information etc. Mutual funds have come as a great help to all retail investors. It is a special type of institutional mechanism or an investment method through which the small as well as large investors pool their savings which are invested under the

advice of a team of professionals in large variety of portfolios of corporate securities Safety with good return on investment is the outcome of these professional investment in mutual funds.

(4) Mutual Funds as part of financial inclusion policy of Govt. of India: Now SEBI is motivating mutual funds to spread in smaller cities and in rural India to attract small savings and making rural people aware of new investment avenue like mutual fund providing good returns at low risk. So Govt. of India policy of financial inclusion to mobilise savings of unbanked people of India is being supported actively by mutual funds now. In its effort to encourage investments from smaller cities, SEBI allowed AMCs to hike expense ratio up to 0.3 per cent on the condition of generating more than 30 per cent inflow from smaller cities.

Role of investment bankers:

Issuing stocks and bonds is one of the primary ways for a company to raise capital. But executing these transactions requires special expertise, from pricing financial instruments in a way that will maximize revenues to navigating regulatory requirements. That's where an investment bank usually comes into the picture.

In essence, investment banks are a bridge between large enterprises and the investor. Their primary roles are to advise businesses and governments on how to meet their financial challenges and to help them procure financing, whether it be from stock offerings, bond issues, or derivative products.

Role as an Advisor

Deciding how to raise capital is a major decision for any company or government. In most cases, they lean on an investment bank—either a large Wall Street firm or a "boutique" banker—for guidance.

Taking into account the current investing climate, the bank will recommend the best way to raise funds. This could entail selling an ownership stake in the company through a stock offer or borrowing from the public through a bond issue. The investment firm can also help determine how to price these instruments by utilizing sophisticated financial models.

In the case of a stock offering, its financial analysts will look at a variety of different factors—such as earnings potential and the strength of the management team—to estimate how much a share of the company is worth. If the client is offering bonds, the bank will look at prevailing interest rates for similarly rated businesses to figure out how much it will have to compensate borrowers.

Investment banks also offer advice in a merger or acquisition scenario. For example, if a business is looking to purchase a competitor, the bank can advise its management team on how much the company is worth and how to structure the deal in a way that's favorable to the buyer.

Underwriting Stocks and Bonds

If an entity decides to raise funds through an equity or debt offering, one or more investment banks will also underwrite the securities. This means the institution buys a certain number of shares or bonds at a predetermined price and re-sells them through an exchange.

Suppose Acme Water Filter Company hopes to obtain $1 million in an initial public offering. Based on a variety of factors, including the firm's expected earnings over the next few years, Federici Investment Bankers determines that investors will be willing to pay $11 each for 100,000 shares of the company's stock. As the sole underwriter of the issue, Federici buys all the shares at $10 apiece from Acme. If it manages to sell all 100,000 at $11, the bank makes a nice $100,000 profit (100,000 shares x $1 spread).

However, depending on its arrangement with the issuer, Federici may be on the hook if the public's appetite is weaker than expected. If it has to lower the price to an average of $9 a share to liquidate its holdings, it's lost $100,000. Therefore, pricing securities can be tricky. Investment banks generally have to outbid other institutions that also want to handle the transaction on behalf of the issuer. But if their spread isn't big enough, they won't be able to squeeze a healthy return out of the sale.

Other Activities:

Research: Larger investment banks have large teams that gather information about companies and offer recommendations on buying or selling their stock. They may use these reports internally but can also generate revenue by selling them to hedge funds and mutual fund managers.

Trading and Sales: Most major firms have a trading department that can execute stock and bond transactions on behalf of their clients. In the past, some banks have also engaged in proprietary trading, where they essentially gamble their own money on securities; however, a recent regulation known as the Volcker Rule has clamped down on these activities.

Asset Management: The likes of J.P. Morgan and Goldman Sachs manage enormous portfolios for pension funds, foundations, and insurance companies through their asset management department. Their experts help select the right mix of stocks, debt instruments, real estate trusts, and other investment vehicles to achieve their clients' unique goals.

Wealth Management: Some of the same banks that perform investment banking functions for Fortune 500 businesses also cater to retail investors. Through a team of financial advisors, they help individuals and families save for retirement and other long-term needs.

Securitized Products: These days, companies often pool financial assets—from mortgages to credit card receivables—and sell them off to investors as fixed-income products. An investment bank will

recommend opportunities to "securitize" income streams, assemble the assets, and market them to institutional investors.

13. How do you calculate the stock market indices?

Stock Market Index

A stock market index measures the performance of the entire market or a subset thereof. A selected group of stocks that reflect the state of either the entire market or a segment of the market constitutes the index.

Fluctuations in the prices of the stocks are an indicator of market movements, and investors can compare price levels in different periods to evaluate market performance.

BSE CALCULATION:

BSE Sensex value calculation uses Free Float Market Capitalization method. Earlier, the Sensex used the weighted market capitalization method. However, from September 1st, 2003, the free-float market capitalization method has been in use. Upon selecting the 30 stocks for the index, it uses the free float market capitalization method to calculate the value of the index.

- ✓ The first step is to determine the free float market capitalization of 30 companies that form the index.

Free Float Market Capitalization = Market Capitalization * Free Float Factor.

Free Float factor is the percentage of total shares a company issues and that are readily available to the common public to trade. This also means the total outstanding shares of the company. Additionally, the shares issued to the promoters, the government, etc. that are not available for trading on the market are not included. The market capitalization is the market value of the company.

Market capitalization = Share price per share * number of shares issued by the company

- ✓ Once the free float market capitalization is determined. The value of BSE Sensex can be calculated using the formula below.

BSE Sensex calculation

Value of Sensex = (Total free float market capitalization/ Base market capitalization) * Base period index value.

The base period (year) for Sensex calculation is 1978-79. The base value index is 100. Using the above formula, one can calculate the value of BSE Sensex.

NIFTY CALCULATION:

The NIFTY 50 index is calculated using a process called the free-float market capitalization-weighted method. It reflects the total market value of all stocks in the index relative to a base period value (November 3, 1995).

Market capitalization, or market cap, is the total value of a company's shares held by all investors, including the organization itself. Free-float market cap captures the total market value of those shares which are available for public trading, that is, that are not held by company owners or the government.

Using the weighted method means that the component of each stock in calculating the index is assigned a weight according to the total value of its outstanding shares.

The total market cap of each stock is computed by multiplying it with a float-factor or Investible Weight Factor (IWF). It considers only those shares that are available for public trading and exclude the following categories:

- ✓ Shares held by company owners and promoters
- ✓ Shares held by the government
- ✓ Shares held through American/Global Depository Receipts (shares held by foreigners indirectly through foreign financial institutions in India)
- ✓ Strategic stakes by corporate bodies
- ✓ Investments held under FDI
- ✓ Shares held by associate companies (cross-holdings)
- ✓ Employee Welfare Trusts (for example, shares given to employees of the company as some form of security)
- ✓ Locked-in shares (shares that cannot be traded, due to some regulation imposed on the company by a regulatory authority)

Market capitalization = Shares Outstanding * Current Price

Free-float Market Capitalization = Market Cap * IWF

Index Value = (Current Market Value/Base Market Capital) * 1000

The current market value is the weighted aggregate market cap of all the 50 companies. The base market capital is the weighted aggregate market cap of all 50 companies as in the base period.

UNIT IV DEBT MARKET AND FOREX MARKET

Bond markets in India: Government bond market and its interface with capital market - Components of bond market - G-Sec, T-Bills, Corporate Bonds, Yield conventions, Role of primary dealers, Auction Markets - Pricing of Bonds

Introduction to Forex markets, basics in exchange rates theory - Forex risk exposures and basics of corporate forex risk management

PART – A

1. What is debt market?

Debt market refers to the financial market where investors buy and sell debt securities, mostly in the form of bonds.

2. Classify the Indian debt market.

Classification of Indian Debt Market: Indian debt market can be classified into two categories:

- ✓ Government Securities Market (G-Sec Market)
- ✓ Bond Market

3. Define G-Sec market.

It consists of central and state government securities. It means that loans are being taken by the central and state governments. The government securities market accounts for more than 90 percent of the turnover in the debt market.

4. What is bond market?

It consists of financial institutions bonds, corporate bonds and debentures and public sector unit's bonds. These bonds are issued to meet financial requirements at a fixed cost, and hence, remove uncertainty in financial costs.

5. List the different kinds of debt instruments.

- ✓ The NSE Wholesale Debt Market Segment (WDM)
- ✓ Government Securities
- ✓ Corporate Bonds
- ✓ Certificate of Deposits

- ✓ Commercial Papers
- ✓ Zero Coupon Bonds (ZCB) & Convertible Bond

6. Define government securities.

   It is the Reserve Bank of India that issues Government Securities or G-Secs on behalf of the Government of India. These securities have a maturity period of 1 to 30 years. G-Secs offer a fixed interest rate.

7. What is meant by corporate bond?

   These bonds come from PSUs and Private corporations and are offered for an extensive range of tenure up to 15 years.

8. What is meant by CD?

   CDs are documents of title to time deposits with banks. They are interest bearing, maturity dated obligations of banks and are technically a part of bank deposits. They represent bank deposit accounts which are transferable.

9. Define commercial paper.

   Commercial papers were introduced in January 1990, to enable highly- rated corporate borrowers to diversify their sources of short term borrowings and also provide an additional instrument to the investor.

10. Define ZCB.

    ZCBs are available at a discount on their face value. There is no interest paid on these instruments but on maturity the face value is redeemed from the RBI.

11. What are the types of government bonds?

    - ✓ Treasury bills (T-bills) expire in less than one year
    - ✓ Treasury notes (T-notes) expire in one to ten years
    - ✓ Treasury bonds (T-bonds) expire in more than ten years

12. What is T-bills?

    Treasury bills, also known as T-bills, are short term money market instruments. The RBI on behalf of the government to curb liquidity shortfalls. It is a promissory note with a guarantee of payment at a later date. The funds collected are usually used for short term requirements of the government. It is also used to reduce the overall fiscal deficit of the country.

13. Who is PD?

    Primary dealers are registered entities with the RBI who have the license to purchase and sell government securities. They are entities who buys government securities directly from the RBI (the RBI issues government securities on behalf of the government), aiming to resell them to other buyers.

14. What is meant by an auction market?

    An auction market is a stage for buyers and sellers to trade stocks by making competing bids and offers. It executes at a matching price where the buyer's highest bid matches the seller's lowest offer price.

15. List the characteristics of bond pricing.

    Bond pricing is an empirical matter in the field of financial instruments. The price of a bond depends on several characteristics inherent in every bond issued. These characteristics are:

    - ✓ Coupon, or lack thereof
    - ✓ Principal/par value
    - ✓ Yield to maturity
    - ✓ Periods to maturity

16. What is FOREX Market?

    The foreign exchange market (forex, FX, or Currency Market) is a global decentralized market for the trading of currencies. The foreign exchange market determines the relative values of different currencies. Electronic Broking Services (EBS) and Reuters 3000 extra are two main interbank FX trading platforms.

17. List the types of Forex Transactions.

    - ✓ The Forex Spot Market
    - ✓ The Forex Forward Market
    - ✓ Forex Futures

18. List the exchange rates theory in forex market.

    For the determination of the par values of different currencies, alternative theoretical explanations have been given.

Some of the prominent explanations or theories include:

- ✓ Mint Parity Theory
- ✓ The Purchasing Power Parity Theory
- ✓ The Balance of Payments Theory

19. What is Foreign Exchange Risk?

Foreign exchange risk is the chance that a company will lose money on international trade because of currency fluctuations. Also known as currency risk, FX risk and exchange rate risk, it describes the possibility that an investment's value may decrease due to changes in the relative value of the involved currencies

20. List the types of Foreign Exchange Risk

- ✓ Transaction Risk
- ✓ Translation Risk
- ✓ Economic Risk

PART – B

1. What is debt market? Explain the classification of debt market in detail.

Debt market refers to the financial market where investors buy and sell debt securities, mostly in the form of bonds. These markets are important sources of funds, especially in a developing economy like India's. India's debt market is one of the largest markets in Asia. The total size of the Indian debt market is currently estimated to be in the range of USD 150 billion to 200 billion. India's debt market accounts for approximately 30 percent of its GDP. The Indian debt market in terms of volume is larger than the equity market.

The most distinguishing features of the debt market instruments of Indian debt market are that the return is fixed. This means, returns are almost risk-free. This fixed return on the bond is often termed as the 'coupon rate' or the 'interest rate'. Therefore, the buyer (of bond) is giving the seller a loan at a fixed interest rate, which equals the coupon rate.

Classification of Indian Debt Market: Indian debt market can be classified into two categories:

- ✓ Government Securities Market (G-Sec Market): The government securities market is at the core of financial markets. Activity in the government securities market can affect the overall investment in the economy. It consists of central and state government securities. It means that loans are being taken by the central and state governments. The government securities market

accounts for more than 90 percent of the turnover in the debt market. It constitutes the principal segment of the debt market.

- ✓ Bond Market: It consists of financial institutions bonds, corporate bonds and debentures and public sector unit's bonds. These bonds are issued to meet financial requirements at a fixed cost, and hence, remove uncertainty in financial costs. The Indian bond market, measured by the estimated value of the bonds outstanding, is next only to the Japanese and Korean bond markets in Asia.

Different types of Debt Instruments

- ✓ The NSE Wholesale Debt Market Segment (WDM) has emerged as an active platform for trading in debt instruments. BSE also started trading in debt instruments. The different types of debt instruments available in the Indian debt market are the following.
- ✓ Government Securities: It is the Reserve Bank of India that issues Government Securities or G-Secs on behalf of the Government of India. These securities have a maturity period of 1 to 30 years. G-Secs offer a fixed interest rate, where interests are paid semi-annually. As government security is a claim on the Government, it is an absolutely secured financial instrument which guarantees the certainty of both income and capital. It is, therefore, also called a 'gilt-edged' (which means of the best quality) security or stock.
- ✓ Corporate Bonds: These bonds come from PSUs and Private corporations and are offered for an extensive range of tenure up to 15 years. Compared to government securities corporate bonds carry higher risk, which depend upon the corporation, the industry where the corporation is currently operating, the current market conditions, and the rating of the corporation. However, these bonds also give the higher returns than the G-Secs.
- ✓ Certificate of Deposits: Certificates of deposits are being issued in India since 1989, by banks, either directly to the investors or through the dealers. CDs are documents of title to time deposits with banks. They are interest bearing, maturity dated obligations of banks and are technically a part of bank deposits. They represent bank deposit accounts which are transferable. CDs are marketable or negotiable money market instruments in bearer form and are known as Negotiable Certificates of Deposit. Banks can issue CDs with maturity period of not less than 7 days and not more than one year, from the date of issue.
- ✓ Commercial Papers: Commercial papers were introduced in January 1990, to enable highly- rated corporate borrowers to diversify their sources of short term borrowings and also provide an additional instrument to the investor. These are issued with the maturity of 7 to 365days. CPs are issued by corporate entities at a discount on face value.
- ✓ Zero Coupon Bonds (ZCB): ZCBs are available at a discount on their face value. There is no interest paid on these instruments but on maturity the face value is redeemed from the RBI. A bond of face value 100 will be available at a discount say at Rs.80 and the date of maturity is after two years. This implies an interest rate on the instrument. When the bonds are redeemed, Rs 100 will be paid. The securities do not carry any coupon or interest rate that is unlike dated securities

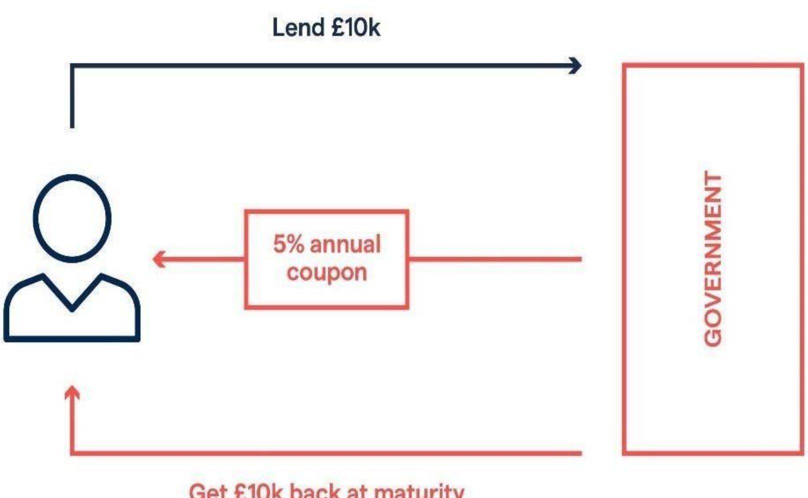
no interest is paid out every year.

- ✓ Convertible Bond: In a convertible bond the holder of the bonds has the option to convert the bond into equity at a fixed conversion price.

2. Discuss in detail about government bond market.

What are government bonds?

A government bond is a type of debt-based investment, where you loan money to a government in return for an agreed rate of interest. Governments use them to raise funds that can be spent on new projects or infrastructure, and investors can use them to get a set return paid at regular intervals.



In the US, government-issued bonds are known as Treasuries. In the UK, they're called gilts. While all investment incurs risk, government bonds from established and stable economies are regarded as being comparatively low-risk investments.

How do government bonds work?

When you buy a government bond, you lend the government an agreed amount of money for an agreed period of time. In return, the government will pay you back a set level of interest at regular periods, known as the coupon. This makes bonds a fixed-income asset.

Once the bond expires, your original investment amount – called the principal – will be returned to you. The day on which you receive the principal is called the maturity date. Different bonds will come with different maturity dates – you could buy a bond that matures in less than a year, or one that matures in 30 years or more.

Key bond terms to remember

- ✓ Maturity: a bond's time to maturity is the length of time until it expires and it makes its final payment – i.e. its active lifespan
- ✓ Principal: the principal amount – or 'face value' – of a bond is the amount it agrees to pay the bondholder, excluding coupons. In general, this is paid as a lump sum when the bond matures or expires
- ✓ Bond price: the issue price of a bond should, in theory, equal a bond's face value as this is the full amount of the loan. But, the price of a bond on the secondary market – after it's been issued – can fluctuate substantially depending on a variety of factors
- ✓ Coupon dates: coupon dates are the dates on which the bond issuer is required to pay the coupon. The bond will specify these, but as a matter of course, coupons are paid annually, semi-annually, quarterly or monthly
- ✓ Coupon rate: the coupon rate of a bond is the value of the bond's coupon payments expressed as a percentage of the bond's principal amount. For example, if the principal (or face value) of a bond is £1000, and it pays an annual coupon of £50, its coupon rate is 5% per annum. Coupon rates are generally annualized, so two payments of £25 will also return a 5% coupon rate

A bond with a price that's equal to its face value is said to be trading at par – if its price drops below par it's said to be trading at a discount, and if its price rises above par it's trading at a premium.

What are the risks of government bonds?

You might hear investors say that a government bond is a risk-free investment. Since a government can always print more money to meet its debts, the theory goes, you'll always get your money back when the bond matures.

In reality, the picture is more complicated. Firstly, governments aren't always able to produce more capital. And even when they can, it doesn't prevent them from defaulting on loan payments. But

aside from credit risk, there are a few other potential pitfalls to watch out for with government bonds: including risk from interest rates, inflation and currencies.

- ✓ Interest rate risk is the potential that rising interest rates will cause the value of your bond to fall. This is because of the effect that high rates have on the opportunity cost of holding a bond when you could get a better return elsewhere.
- ✓ Inflation risk is the potential that rising inflation will cause the value of your bond to fall. If the rate of inflation rises above the coupon rate of your bond, then your investment will lose you money in real terms. Index-linked bonds are less exposed to inflation risk.
- ✓ Currency risk only applies if you buy a government bond that pays out in a currency that is different to your reference currency. In this case, fluctuating exchange rates may cause the value of your investment to drop.
- ✓ Government bonds are guaranteed by the full faith and backing of their respective governments. It's important to note, however, that even government bonds are subject to numerous risks, including credit risk.

What are the types of government bonds?

The terminology surrounding bonds can make things appear much more complicated than they actually are. That's because each country that issues bonds uses different terms for them.

In the US, bonds are referred to as Treasuries. They come in three broad categories, according to their maturity:

- ✓ Treasury bills (T-bills) expire in less than one year
- ✓ Treasury notes (T-notes) expire in one to ten years
- ✓ Treasury bonds (T-bonds) expire in more than ten years

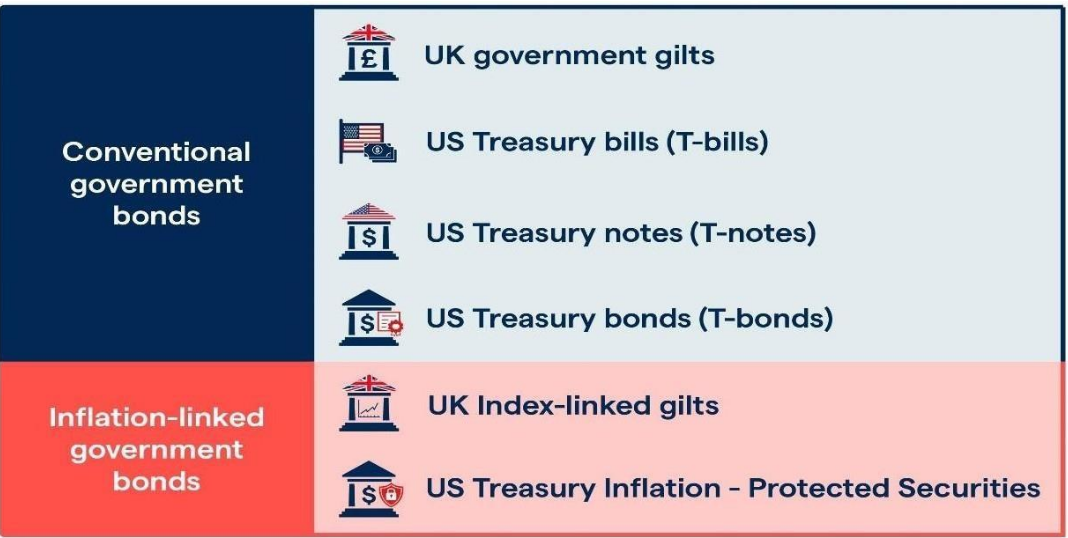
Government bonds from the UK, India and other Commonwealth countries, for example, are referred to as gilts. The maturity of each gilt is listed in the name, so a UK government bond that matures in two years is called a two-year gilt.

Other countries will use different names for their bonds – so if you want to trade bonds from governments outside of the US or UK, it's a good idea to research each market individually.

Index-linked bonds

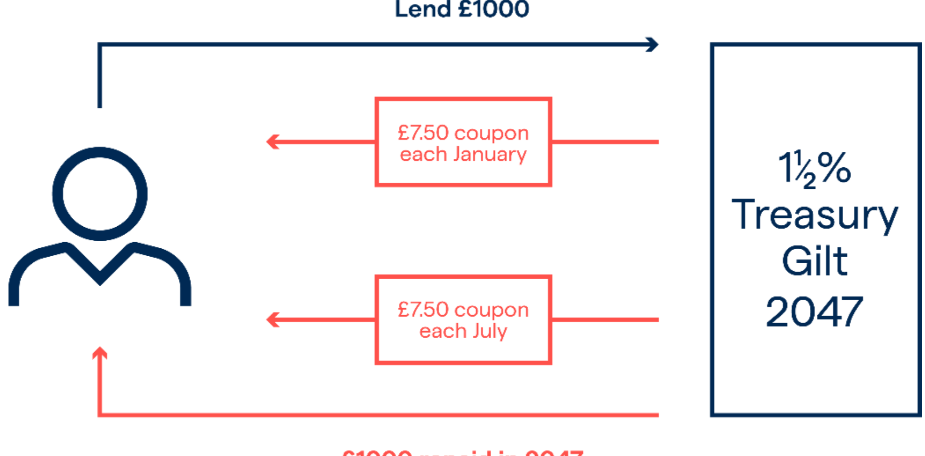
There are also government bonds that don't have fixed coupons – instead, the interest payments will move in line with inflation rates. In the US, these are linked to the CPI and are called Treasury

Inflation-Protected Securities (TIPS). In the UK, they're referred to as index-linked gilts, and the coupon moves with the UK retail prices index (RPI).



Example of UK government gilt

An example of a conventional UK government gilt is the '1½% Treasury Gilt 2047'. The date of maturity on the bond is 2047, and the coupon rate is 1.5% per year. Here, there would be two equal coupon payments, six months apart. With a £1000 nominal of 1½% Treasury Gilt 2047, there would be two coupon payments of £7.50 each on 22 January and 22 July.



What affects the price of government bonds?

✓ Supply and demand

As with all financial assets, government bond prices are dictated by supply and demand. The supply of government bonds is set by each government, who'll issue new bonds as and when they're needed.

Demand for bonds is dependent on whether the bond looks like an attractive investment.

✓ Interest rates

Interest rates can have a major impact on the demand for bonds. If interest rates are lower than the coupon rate on a bond, demand for that bond will likely rise as it represents a better investment. But if interest rates rise above the coupon rate of the bond, demand will potentially drop.

How close the bond is to maturity?

Newly issued government bonds will always be priced with current interest rates in mind. This means that they usually trade at or near their par value. By the time a bond has reached maturity, it's just a pay out of the original loan – i.e. bonds move back towards their par values as they near this point.

The number of interest rate payments remaining before a bond matures will also have an impact on its price.

- ✓ Credit ratings

Government bonds are usually viewed as low-risk investments, because the likelihood of a government defaulting on its loan payment tends to be low. But defaults can still happen, and a riskier bond will usually trade at a lower price than a bond with lower risk and a similar interest rate.

The main way of assessing the risk of a government defaulting is through its rating from the three main credit rating agencies – Standard & Poor's, Moody's, and Fitch Ratings.

- ✓ Inflation

A high inflation rate is usually bad news for bondholders. There are two main reasons for this:

The fixed coupon payment becomes less valuable to investors when the purchasing power of the coupon amount declines owing to inflation

Interest rates are often increased by central monetary authorities like the Bank of England (BoE) when high inflation sets in. Because interest rates and bond prices are inversely related, the higher interest rates result in a lower market price for the bond.

How to trade government bond futures?

To speculate on interest rates, or to hedge against interest rate risk and inflation, you could consider trading the government bond futures market. With us, you can do this by taking a position using CFDs. With CFDs, you would put down a small deposit (called margin) to open a larger position, but your profits and losses will be calculated on the position's full size rather than your smaller margin amount.

It's important to note that leveraged financial products are complex and carry inherent risk. While leverage enables you to gain more profit for less capital if you predict the market movement correctly, you can also lose far more if the market moves against you. So, unlike owning bonds outright, your loss isn't limited to the bond's underlying value.

Why do people trade government bonds?

- ✓ Speculate on interest rate movements
- ✓ Hedge against interest rate increases on existing bond investments
- ✓ Hedge against high inflation on existing fixed-income investments

3. What is bond? Discuss the types of bonds in detail.

A bond is essentially a loan an investor makes to a borrower. As with loans that you take out yourself, bond investors expect to receive full repayment of what was borrowed and consistent interest payments.

Many investors value bonds for the regular income they offer through these interest payments, as well as the comparative safety they provide compared to stocks. While stock values fluctuate day to day, highly rated bonds essentially assure investors that they will see repayment of the amount they invested plus modest interest. Going back more than 90 years, investment-grade bonds as a category have not had a single 5- or 10-year period in which they offered negative returns.

This makes them valuable ways for investors to help diversify and minimize the risk in their investment portfolios. For more on the role bonds can play in a portfolio, see our guide to diversification.

How do bonds work?

There are a few key terms to keep in mind when it comes to understanding how bonds work:

Issuer - This is the government, government-sponsored enterprise, or company that seeks to fund its activities with a loan. It issues bonds as part of its promise to repay its debts.

Maturity date - Generally, this is when you will receive repayment of what you loaned an issuer (assuming the bond doesn't have any call or redemption features). If you want or need to sell a bond before its maturity date, you may be able to sell it to someone else, though there is no guarantee you will get what you paid.

Face value (a.k.a. par value) - This is the value the bond holder will receive at maturity unless the issuer fails to repay the loan, a practice called defaulting. Investors usually pay par when they buy a bond from the issuer, unless it's a zero-coupon bond, which we cover more below. If investors buy the bond from someone else (meaning they buy it on a secondary market), they may pay more or less than face value. Check out our guide on bond prices, rates, and yields for more on how bond rates change over time.

Coupon rate - This is the annual percentage of interest the issuer pays someone who owns a bond. The term "coupon" originates from when bond certificates were issued on paper and had actual coupons that investors would detach and bring to the bank to collect the interest. Bonds may have fixed, unchangeable rates or floating coupon rates, meaning they adjust over time based on a predetermined formula. Most bonds make interest payments semiannually based on the principal (the amount they originally borrowed), although some bonds offer monthly and quarterly payments.

Bond rating - Bond ratings indicate the financial health of the issuer and how likely they are to repay their debts. Ratings agencies such as Standard & Poor's, Moody's, and Fitch assign a rating that indicates their opinion of whether the bond is "investment grade" or not. Higher-rated bonds are considered safer and can be attractive even with lower interest rates, whereas lower-rated bonds pay higher interest rates to compensate investors for taking on more perceived risk. An issuer's bond or credit rating can change over time.

Callability - Callable bonds are bonds that the issuer can repay, or call back, early. Issuers may recall bonds if interest rates fall low enough that they can issue comparable new bonds at substantially lower rates and save money overall. The attraction of callable bonds for investors is that they typically offer higher rates than non-callable bonds, though there is no guarantee that they would be able to find a similar rate on a new bond—or even one equal to the current market rate when they buy their callable bond—if their bond is recalled. Callable bonds often have guidelines governing how soon they can be recalled and if the issuer must pay a premium on the principal if they do.

Zero-coupon bonds - Also known as "strips," these are bonds that do not make periodic interest payments. In other words, there's no coupon. Instead, you buy the bond at a discount on its face value and receive one payment of the full face value at maturity. For example, you might pay $16,000 now on a 10-year zero-coupon bond with a face value of $20,000. In a decade, when the bond is mature, you'll receive a payment of $20,000. Perhaps the best-known example of a zero-coupon bond is a US savings bond. Note: Investors interested in bonds may also consider brokered certificates of deposit (CDs), which work similarly to bonds: Not only do they return their full par value at maturity but they are also FDIC-insured, meaning they guarantee the return of your principal up to the FDIC limits. For more on CDs, see What is a CD?

Types of bonds

- ✓ Treasury bonds

The US Treasury issues bonds to pay for government activities and to service the national debt. Treasuries are considered to be extremely low risk if held to maturity, since they are backed by "the full faith and credit" of the US government. Because of their safety, they tend to offer lower yields than other bonds. Income from Treasury bonds is exempt from state and local taxes.

- ✓ Agency bonds

Government-sponsored enterprises (GSEs), like Fannie Mae, Freddie Mac, and the Tennessee Valley Authority, issue bonds to support their mandates. That typically involves ensuring certain segments of the population—like farmers, students, and homeowners—can borrow at affordable rates.

Yields are higher than government bonds, representing their higher level of risk, though are still considered to be on the lower end of the risk spectrum. Some agency bonds, like Fannie Mae and Freddie Mac, are taxable. Others are exempt from state and local taxes.

- ✓ Municipal bonds

Municipal bodies, like states, cities, counties, and towns, issue bonds to pay for public projects (think: roads, sewers) and to finance other activities. The majority of these bonds, commonly called munis, are exempt from federal income taxes and, in most cases, also exempt from state and local taxes if the investor is a resident of the state that issues them. As a result, the yields tend to be lower but still may provide more after-tax income for investors in higher tax brackets.

- ✓ Corporate bonds

Companies issue bonds to expand, modernize, cover expenses, and finance other activities. The yield is generally higher than government and municipal bonds, though they do carry more risk. Bond rating agencies help you assess that risk by grading the bonds based on the issuing company's creditworthiness, or how likely it is to repay its loans. Income from corporate bonds is fully taxable.

- ✓ Mortgage-backed securities (MBS)

Banks and other lending institutions pool mortgages and "securitize" them so investors can buy bonds that are backed by income from people repaying their mortgages. This raises money so the lenders can offer more mortgages. Examples of MBS issuers include Ginnie Mae, Fannie Mae, and Freddie Mac. Mortgage-backed bonds have a yield that typically exceeds high-grade corporate bonds.

The major risk of these bonds is that if borrowers repay their mortgages in a "refinancing boom," it could have an impact on the investment's average life and potentially its yield. These bonds can also prove risky if many people default on their mortgages. Mortgage-backed bonds are fully taxable.

- ✓ High-yield bonds

Some issuers simply aren't as creditworthy as others and must offer what are known as high-yield bonds. High-yield issuers can be local and foreign governments, but they're most commonly companies that are considered by bond ratings agencies to be at greater risk of not paying interest and/or returning principal at maturity. As a result, the issuer will pay a higher rate to entice investors to take on the added risk. These bonds are frequently rated below investment grade by credit agencies and are considered speculative; you may also hear them referred to as "junk bonds."

How to buy bonds

Most investors get exposure to different types of bonds through bond funds. These may be through mutual funds or exchange-traded funds (ETFs). In either case, they are researched and curated by professionals or aim to recreate the performance of indexes tracking leading bonds. Bond funds allow you to minimize your risk by investing in potentially hundreds of bonds at once and can readily be bought through regular investment accounts, like taxable brokerage accounts, individual retirement accounts (IRAs), and 401(k)s. In addition, you can easily sell shares regardless of bond maturity dates.

Some investors may choose to research and invest in new-issue and secondary market individual bonds through their brokerages. Investing in bonds this way allows investors to hold bonds to their maturity dates and avoid losses caused by price volatility. Doing so, however, requires a greater knowledge of the bond industry, credit ratings, and risk, and single bonds may be more difficult to sell quickly before their maturity date.

4. Discuss the term corporate bond in detail.

What Is a Corporate Bond?

A corporate bond is a type of debt security that is issued by a firm and sold to investors. The company gets the capital it needs and in return the investor is paid a pre-established number of interest payments at either a fixed or variable interest rate. When the bond expires, or "reaches maturity," the payments cease and the original investment is returned.

The backing for the bond is generally the ability of the company to repay, which depends on its prospects for future revenues and profitability. In some cases, the company's physical assets may be used as collateral.

In the investment hierarchy, high-quality corporate bonds are considered a relatively safe and conservative investment. Investors building balanced portfolios often add bonds in order to offset riskier investments such as growth stocks. Over a lifetime, these investors tend to add more bonds and fewer risky investments in order to safeguard their accumulated capital. Retirees often invest a larger portion of their assets in bonds in order to establish a reliable income supplement.

In general, corporate bonds are considered to have a higher risk than U.S. government bonds. As a result, interest rates are almost always higher on corporate bonds, even for companies with top-flight credit quality. The difference between the yields on highly-rated corporate bonds and U.S. Treasuries is called the credit spread.

Corporate Bond Ratings

Before being issued to investors, bonds are reviewed for the creditworthiness of the issuer by one or more of three U.S. rating agencies: Standard & Poor's Global Ratings, Moody's Investor Services, and Fitch Ratings.

Each has its own ranking system, but the highest-rated bonds are commonly referred to as "Triple-A" rated bonds. The lowest rated corporate bonds are called high-yield bonds due to their greater interest rate applied to compensate for their higher risk. These are also known as "junk" bonds.

Bond ratings are vital to alerting investors to the quality and stability of the bond in question. These ratings consequently greatly influence interest rates, investment appetite, and bond pricing.

How Corporate Bonds Are Sold

Corporate bonds are issued in blocks of $1,000 in face or par value. Almost all have a standard coupon payment structure. Typically, a corporate issuer will enlist the help of an investment bank to underwrite and market the bond offering to investors.

The investor receives regular interest payments from the issuer until the bond matures. At that point, the investor reclaims the face value of the bond. The bonds may have a fixed interest rate or a rate that floats according to the movements of a particular economic indicator.

Corporate bonds sometimes have call provisions to allow for early prepayment if prevailing interest rates change so dramatically that the company deems it can do better by issuing a new bond.

Investors may also opt to sell bonds before they mature. If a bond is sold, the owner gets less than face value. The amount it is worth is determined primarily by the number of payments that still are due before the bond matures. Investors may also gain access to corporate bonds by investing in any number of bond-focused mutual funds or ETFs.

Why Corporations Sell Bonds

Corporate bonds are a form of debt financing. They are a major source of capital for many businesses, along with equity, bank loans, and lines of credit. They often are issued to provide the ready cash for a particular project the company wants to undertake. Debt financing is sometimes preferable to issuing stock (equity financing) because it is typically cheaper for the borrowing firm and does not entail giving up any ownership stake or control in the company.

Generally speaking, a company needs to have consistent earnings potential to be able to offer debt securities to the public at a favorable coupon rate. If a company's perceived credit quality is higher, it can issue more debt at lower rates. When a corporation needs a very short-term capital boost, it may sell commercial paper, which is similar to a bond but typically matures in 270 days or less.

The Difference Between Corporate Bonds and Stocks

An investor who buys a corporate bond is lending money to the company. An investor who buys stock is buying an ownership share of the company.

The value of a stock rises and falls, and the investor's stake rises or falls with it. The investor may make money by selling the stock when it reaches a higher price, or by collecting dividends paid by the company, or both.

By investing in bonds, an investor is paid in interest rather than profits. The original investment can only be at risk if the company collapses. One important difference is that even a bankrupt company must pay its bondholders and other creditors first. Stock owners may be reimbursed for their losses only after all of those debts are paid in full.

Companies may also issue convertible bonds, which are able to be turned into shares of the company if certain conditions are met.

5. Discuss T-bill. Explain how it was calculated in detail.

What are Treasury Bills in India?

Treasury bills, also known as T-bills, are short term money market instruments. The RBI on behalf of the government to curb liquidity shortfalls. It is a promissory note with a guarantee of payment at a later date. The funds collected are usually used for short term requirements of the government. It is also used to reduce the overall fiscal deficit of the country.

Treasury bills or T-bills have zero-coupon rates, i.e. no interest is earned on them. Individuals can purchase T-bills at a discount to the face/value. Later, they are redeemed at a nominal value, thereby allowing the investors to earn the difference. For example, an individual purchase a 91-day T-bill which has a face value of Rs.100, which is discounted at Rs.95. At the time of maturity, the T-bill holder gets Rs.100, thus resulting in a profit of Rs.5 for the individual.

Therefore, it is an essential monetary instrument that the Reserve Bank of India uses. It helps RBI to regulate the total money supply in the economy as well as raising funds.

Types of Treasury Bills

Four types of treasury bills are auctioned. The primary distinction for these treasury bills is their holding period.

- ✓ 14-day Treasury bill

These bills complete their maturity on 14 days from the date of issue. They are auctioned on Wednesday, and the payment is made on the following Friday. The auction occurs every week. These bills are sold in the multiples of Rs.1lakh and the minimum amount to invest is also Rs.1 lakh.

- ✓ 91-day Treasury bill

These bills complete their maturity on 91 days from the date of issue. They are auctioned on Wednesday, and the payment is made on the following Friday. They are auctioned every week. These bills are sold in the multiples of Rs.25000 and the minimum amount to invest is also Rs.25000.

- ✓ 182-day Treasury bill

These bills complete their maturity on 182 days from the date of issue. They are auctioned on Wednesday, and the payment is made on the following Friday when the term expires. They are auctioned every alternate week. These bills are sold in the multiples of Rs.25000 and the minimum amount to invest is also Rs.25000.

- ✓ 364-day Treasury bill

These bills complete their maturity 364 days from the date of issue. They are auctioned on Wednesday, and the payment is made on the following Friday when the term expires. They are auctioned every alternate week. These bills are sold in the multiples of Rs.25000 and the minimum amount to invest is also Rs.25000.

As mentioned above, the holding period for each bill remains constant. However, the face value and the discount rates of treasury bills can change periodically. This depends on the funding requirements and monetary policy of RBI along with total bids received.

Also, The Reserve Bank of India issues treasury bills calendar for auction. It announces the exact date of the auction, the amount to be auctioned and the maturity dates before every auction.

How to Buy Treasury Bills in India?

T-bills are issued in the primary market through RBI auctions. A qualified investor may participate in a competitive or non-competitive bidding auction.

Competitive Bidding: Institutional investors, such as financial institutions, banks, mutual funds, primary dealers, and insurance companies, are eligible to make competitive bids.

Non-Competitive Bidding: Non-competitive bidders can be individuals, HUF/ trust, firm, corporate body, institution, provident funds and any other parties. Non-competitive bidders can participate in the auctions without having to quote the price/ yield. Hence, one doesn’t have to worry about

whether the bid is on or off the mark. The bidder will be allotted partially or fully in accordance with the plan.

RBI issues an indicative auction calendar that contains information about the borrowing, tenor range and auction duration. During the auction duration, bids can be placed on the electronic platform of

RBI called E-Kuber. E-Kuber is the Core Banking Solution (CBS) platform of RBI.

Competitive bidders who maintain funds or current account and securities account (Subsidiary General Ledger (SGL) account) with RBI are members of the E-Kuber Platform.

Through this electronic platform, all E-Kuber members can submit bids in the auction. RBI publishes the auction results within a stipulated time period for Treasury bills at 1:30 PM.

Non-Competitive bidders can place their bids to purchase T-bills through trading members of the NSE or NSE goBID app. The allotted bonds will directly reflect in the bidder's demat account. Therefore, non-competitive bidders must have a demat account. The following steps will help you place non-competitive bids for T-bills:

- ✓ Login to your demat account.
- ✓ Under the IPO section, select the T-bill that you wish to bid for.
- ✓ Click on Apply.
- ✓ Place your bids.
- ✓ Upon successful application, you will be notified by the trading platform.
- ✓ The allotted bonds will reflect in your account in T+1 days.

Features of Treasury Bills

- ✓ Form

Treasury bills can be issued in a physical form as a promissory note or dematerialized form by crediting to SGL account (Subsidiary General Ledger Account).

- ✓ Minimum Bid Amount

Treasury bills are issued at a minimum price of Rs.25000 and in the same multiples thereof.

- ✓ Issue Price

Treasury bills are issued at a discounted price. However, they are redeemed at par value at the time of maturity.

- ✓ Eligibility

Individuals, companies, firms, banks, trust, insurance companies, provident fund, state government and financial institutions are eligible to purchase T-bills.

- ✓ Highly Liquid

Treasury bills are highly liquid negotiable instruments. They are available in both financial markets, i.e. primary and secondary market.

- ✓ Auction Method

The 91-day T-bill follows a uniform auction method, whereas, 364-day T-bill follows a multiple auction method.

- ✓ Zero Risk

The yields are assured. Hence, they have zero risks of default.

- ✓ Day Count

For treasury bills, the day count is 364 days in a year.

Besides this, it also has other characteristics like market-driven discount rate, selling through auction, issued to meet short term cash flow mismatch, assured yield, low transaction cost, etc.

How to calculate the yield on Treasury bills?

To calculate the yield, the comparison of par value to its face value is the first step. Additionally, investment returns are more useful when expressed on an annualized basis. The next step is to use the maturity period to convert the return to an annual percentage.

You can calculate the yield of treasury bills through the following formula –

$$Y = (100-P)/P * [(365/D)*100]$$, where

Y – Yield/ return percentage of T-bill

P – The discounted price of the T-bill purchased

D – Tenure of T-bill

Let’s understand this with an illustration. If RBI issues a 91- Day treasury bill at the discounted price of Rs.97 while the face value of the bill is Rs.100, the yield of the security can be determined as follows –

Yield = [(100-97)/97] *(365/91*100)

= 12.40%

By annualizing the returns, a shorter Treasury bill can be compared with the following:

- ✓ Long-dated Treasury bill
- ✓ Government bond
- ✓ Corporate bond
- ✓ Treasury bond
- ✓ Any other type of fixed income investment instrument.

Advantages and limitations of treasury bills

Treasury bills investments come with many advantages as it provides safety and security to its investors.

✓ Risk-Free

Treasury bills is a popular short term government security. The Central government backs them. They act as a liability to the Indian government as they need to be paid within a stipulated time.

Therefore, investors have total security on their funds invested as they are backed by the government of India, I.e. the highest authority in the country. The amount has to be paid to the investors even during the crisis.

✓ Highly Liquid

Treasury bill has a highest maturity period of 364 days. They help in raising money for short term requirements for the economy. Individuals who are looking for short term investments can park their funds here. Also, T-bills can be sold in the secondary market. This allows investors to convert their holding into cash during any emergency.

✓ Bidding

Treasury bills are usually auctioned by RBI every week. This allows the retail investors to place their noncompetitive bids. This increases the exposure of investors to the government bond market, which creates higher cash flows to the capital market.

✓ Limitations of Treasury Bills

Compared to other stock market investment tools, treasury bills yield lower returns as they are government-backed debt securities. Treasury bills are zero-coupon bonds, i.e. no interest is paid on them to investors. They are issued at a discount and redeemed at face value. Therefore, the returns earned by investors in T-bills remains fixed throughout the bond tenure irrespective of the economic condition of the country.

Stock market variations influence the returns generated by equity, equity fund, debt fund and debt instruments. Subsequently, when the stock market moves upwards, the yield generated by equity, equity fund, debt fund or debt instruments is also higher. However, the returns generated by T-bills remain fixed irrespective of the financial market movements.

Who should invest in treasury bills?

The government of India issues Treasury bills which are ideal for investors who are looking for secure investment and reasonable returns. RBI facilitates the noncompetitive bids to be placed by the investors. The bidding process of T-bills allows investors to take part in the same by placing their bid. The details regarding the discount value and par value are published beforehand. Investors can get full transparency of the investment process. Also, it helps for wealth creation for individuals.

It is suitable for any investors irrespective of their knowledge and risk tolerance levels. Over and above, it can also add as a secure investment for investors looking for portfolio diversification. This can dilute the risk of overall portfolio allocation.

Even companies, firms, banks, trust, insurance companies, provident fund, state government and financial institutions are eligible to invest in treasury bills.

Treasury bills are the safest fixed income investment instrument in its category as the risk of default is negligible. The yield is also predetermined as the date of issue, the maturity dates and the amount is also fixed. They play a crucial role in regulating the total money supply in the economy.

6. How to compare the yields of different bonds?

Comparing bond yields can be daunting, mainly because they can have varying frequencies of coupon payments. And, because fixed-income investments use a variety of yield conventions, you have to convert the yield to a common basis when comparing different bonds.

Taken separately, these conversions are straightforward. But when a problem contains both compounding period and day-count conversions, the correct solution is harder to reach.

Factors to Consider when Comparing Bond Yields

U.S. Treasury bills (T-bills) and corporate commercial paper investments are quoted and traded in the market on a discount basis. The investor does not receive any coupon interest payments. The profit is in the difference between its current purchase price and its face value at maturity. That is the implicit interest payment.

The amount of the discount is stated as a percentage of the face value, which is then annualized over a 360-day year.

There are baked-in problems with rates quoted on a discount basis. For one thing, discount rates understate the true rate of return over the term to maturity. This is because the discount is stated as a percentage of face value.

It is more reasonable to think of a rate of return as the interest earned divided by the current price, not the face value. Since the T-bill is purchased at less than its face value, the denominator is overly high and the discount rate is understated.

The second problem is that the rate is based on a hypothetical year that has only 360 days.

The Yields on Bank CDs

The returns of bank certificates of deposit historically were quoted on a 360-day year also, and some are to this day. However, since the rate is modestly higher using a 365-day year, most retail CDs are now quoted using a 365-day year.

The returns are posted with their annual percentage yield (APY). This is not to be confused with the annual percentage rate (APR), which is the rate which most banks quote with their mortgages.

In APR calculations, the interest rates received during the period are simply multiplied by the number of periods in a year. But the effect of compounding is not included with APR calculations—unlike APY, which takes the effects of compounding into account.

A six-month CD that pays 3% interest has an APR of 6%. However, the APY is 6.09%, calculated as follows:

$$APY = (1 + 0.03)^2 - 1 = 6.09\%$$ APY=(1+0.03)2−1=6.09%

Yields on Treasury notes and bonds, corporate bonds, and municipal bonds are quoted on a semi-annual bond basis (SABB) because their coupon payments are made semi-annually. Compounding occurs twice per year, using a 365-day year.

Bond Yield Conversions

365 Days versus 360 Days

In order to properly compare the yields on different fixed-income investments, it's essential to use the same yield calculation. The first and easiest conversion changes a 360-day yield to a 365-day yield. To change the rate, simply "gross up" the 360-day yield by the factor 365/360. A 360-day yield of 8% is equal to a 365-day yield of 8.11%. That is:

$$8\% * \{365\} / \{360\} = 8.11$$

Discount Rates

Discount rates, commonly used on T-bills, are generally converted to a bond-equivalent yield (BEY), sometimes called a coupon-equivalent or an investment yield. The conversion formula for "short-dated" bills with a maturity of 182 or fewer days is the following:

$$BEY=365\times DR / 360-(N\times DR)$$

where:

BEY=the bond equivalent yield

DR=the discount rate (expressed as a decimal)

N=of days between settlement and maturity

Long Dates

So-called "long-dated" T-bills have a maturity of more than 182 days. In this case, the usual conversion formula is a little more complicated because of compounding. The formula is:

$$BEY=-2N/365+2[(N/365)^2+(2N/365-1)((N\times DR)/360-(N\times DR)]^1/2\div 2N-1$$

Short Dates

For short-dated T-bills, the implicit compounding period for the BEY is the number of days between settlement and maturity. But the BEY for a long-dated T-bill does not have any well-defined compounding assumption, which makes its interpretation difficult.

BEYs are systematically less than the annualized yields for semi-annual compounding. In general, for the same current and future cash flows, more frequent compounding at a lower rate corresponds to less frequent compounding at a higher rate.

A yield for more frequent than semi-annual compounding (such as is implicitly assumed with both short-dated and long-dated BEY conversions) must be lower than the corresponding yield for actual semi-annual compounding.

BEYs and the Treasury

BEYs reported by the Federal Reserve and financial market institutions should not be used as a comparison to the yields on longer-maturity bonds. The problem isn't that the widely used BEYs are inaccurate. They serve a different purpose—namely, to facilitate comparison of yields on T-bills, T-notes, and T-bonds maturing on the same date.

To make an accurate comparison, discount rates should be converted to a semi-annual bond basis (SABB), because that is the basis commonly used for longer maturity bonds.

To calculate SABB, the same formula to calculate APY is used. The only difference is that compounding happens twice a year. Therefore, APYs using a 365-day year can be directly compared to yields based on SABB.

A discount rate (DR) on an N-day T-bill can be converted directly to a SABB with the following formula:

$$SABB=360/(360-(N\times DR))\times(182.5/N-1)\times 2$$

7. Who is PD? Discuss the roles of a primary dealers.

Primary dealers are registered entities with the RBI who have the license to purchase and sell government securities. They are entities who buys government securities directly from the RBI (the RBI issues government securities on behalf of the government), aiming to resell them to other buyers. In this way, the Primary Dealers create a market for government securities.

The Primary Dealers system in the government securities market was introduced by the RBI in 1995.

The PDs are thus created to promote transactions in government securities market. A facilitating arrangement is essential for selling of government securities as government is the single largest borrower in the market who borrows through the issue of its securities – treasury bills and bonds.

The RBI instructs PDs to have a minimum turnover ratio, bidding ratio, underwriting ratio, secondary market participation etc to ensure that they are active in supporting the trade in government securities. PDs are active in the stock market also for enhancing the trading of government securities.

Eligibility Conditions for PDs

a. Subsidiary of scheduled commercial bank/s and All India Financial Institutions

b. Subsidiaries/ joint ventures set up in India by entities incorporated abroad.

c. Company incorporated under the Companies Act, 1956 and does not fall under (a) or (b).

The applicant for PD should register as an NBFC for at least one year prior to the submission of application. Other conditions like net owned fund etc are mentioned by the RBI.

The decision to authorize PDs will be taken by RBI based on its perception of market needs, suitability of the applicant and the likely value addition to the system. Some other functions besides trading in government securities are also assigned to them.

Role and Functions of Primary Dealers

The role of Primary Dealers is to:

(i) commit participation as Principals in Government of India issues through bidding in auctions

(ii) provide underwriting services

(iii) offer firm buy – sell / bid ask quotes for T-Bills & dated securities

(v) Development of Secondary Debt Market

PDs are performing an exceptional role in giving marketability to government securities. the RBI has elaborated the role of PDs in the following words “PDs are expected to play an active role in the G-Sec market, both in its primary and secondary market segments through various obligations like participating in Primary auction, market making in G-Sec, predominance of investment in G-Sec, achieving minimum secondary market turnover ratio, maintaining efficient internal control system for fair conduct of business etc. A PD is required to have a standing arrangement with RBI based on the execution of an undertaking and the authorization letter issued by RBI every three years. Undertaking will be based on passing of a fresh Board resolution by the PD every three years.”

As on January 2015, there was 21 Primary Dealers in the country. Most of the PDs are started by scheduled commercial banks and are registered as NBFCs. Operations of the PDs are subject to prudential and regulatory guidelines issued by RBI from time to time.

8. What is meant by an auction market?

An auction market is a stage for buyers and sellers to trade stocks by making competing bids and offers. It executes at a matching price where the buyer’s highest bid matches the seller’s lowest offer price.

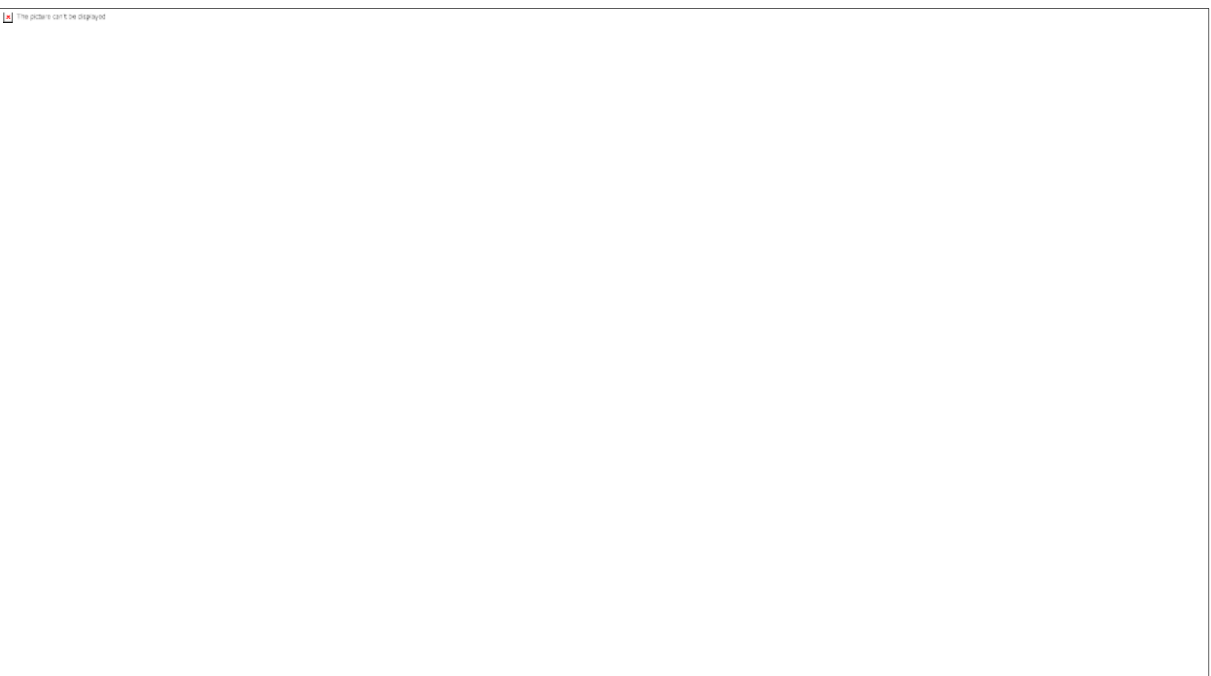
Example

Suppose a buyer is interested in buying a share of ABC Ltd. In the market, it trades at $101 per share. He puts bids as follows: $101.05, $101.10, $101.15, $101.20, $101.25, $101.30. Similarly, sellers willing to sell the same company share in the marketplace offer $101.30, $101.35, $101.40, $101.45,

$101.5, and $101.55. In this scenario, the buyer's highest price is ready to pay, and the lowest price the seller is ready to accept is $101.30. Therefore, the trade gets executed at $101.30, and the current share price of ABC Ltd. will be $101.30. While all other bids of the buyer and ask if the seller remains pending until bids and ask matches and next trades executed in the market.

How does the Auction Market Process Work?

- ✓ The process differs from the OTC market since no direct negotiations occur between buyer and seller.
- ✓ The buyer places multiple bids on the desired financial instrument available in a market.
- ✓ The seller places multiple offers in the desired financial instrument market.
- ✓ The order matching mechanism focuses on putting up the highest bid price from the buyer and the lowest offer price from the seller.
- ✓ If the highest bid price and lowest ask price match. The trade is executed on those securities and decides the current market price on this mechanism.
- ✓ The order status remains pending if the bid price and offer do not match.
- ✓ An order executed will be processed for settlement as per exchange rules.
- ✓ In general, the auction has one seller and multiple buyers. However, in this, there are numerous buyers and sellers.
- ✓ Continuous process deciding the current market price through this order matching mechanism.
- ✓ Auction markets also have the term known as a double auction market, allowing buyers and sellers to submit a price they feel acceptable from a given list of bids and offers. The trade will proceed to execution when bid and ask prices match.



Example

Chicago Mercantile Exchange (CME) and the New York Stock Exchange are still operating in the auction market open outcry system. An electronic trading method that more or less still operates on the principle of an auction market system but electronically, and every buyer and seller gets access to bid and offer prices in the market on display and make their own decisions. Similarly, reduced cost and improved trade execution speed compared to open human outcry speed, an environment that is now less vulnerable to manipulation. In addition, the availability of the electronic system to any home computer and smartphone free of the cost compared to the open outcry auction market created a popularity for adaptation to electronic trading method.

As time passed with the invention of new technology, all exchanges adapted the method of an electronic trading system. In 2007, even NYSE converted from strictly operating on the auction market to a hybrid market, which operates on both the electronic trading system and the auction market. Some stocks are still traded on the trading floor, which has an extremely high price.

In the auction market, they bound brokers by exchange rules, which act as buyers and sellers representing their clients to make competitive bids and offers to make a trade. Therefore, many investors trading in these markets keeps a continuous eye on the news and moods of the trading pit.

Government Securities Auction

Many governments of various countries hold the auction for their securities in the market, which is open to the public and large financial institutions. Bids are mostly accepted electronically and

divided into two groups: competing for bids and non-competing bids. The non-competing buyers are given preference and are guaranteed to receive several securities after the amount as per the minimum and maximum limit of the bid amount. In the case of competitive bids, once the auction is closed, bids are reviewed, and they list competing bids as per bid price. Then, the remaining securities they sell to higher or lower bids.

E.g., The US Treasury holds auctions to finance certain government activities.

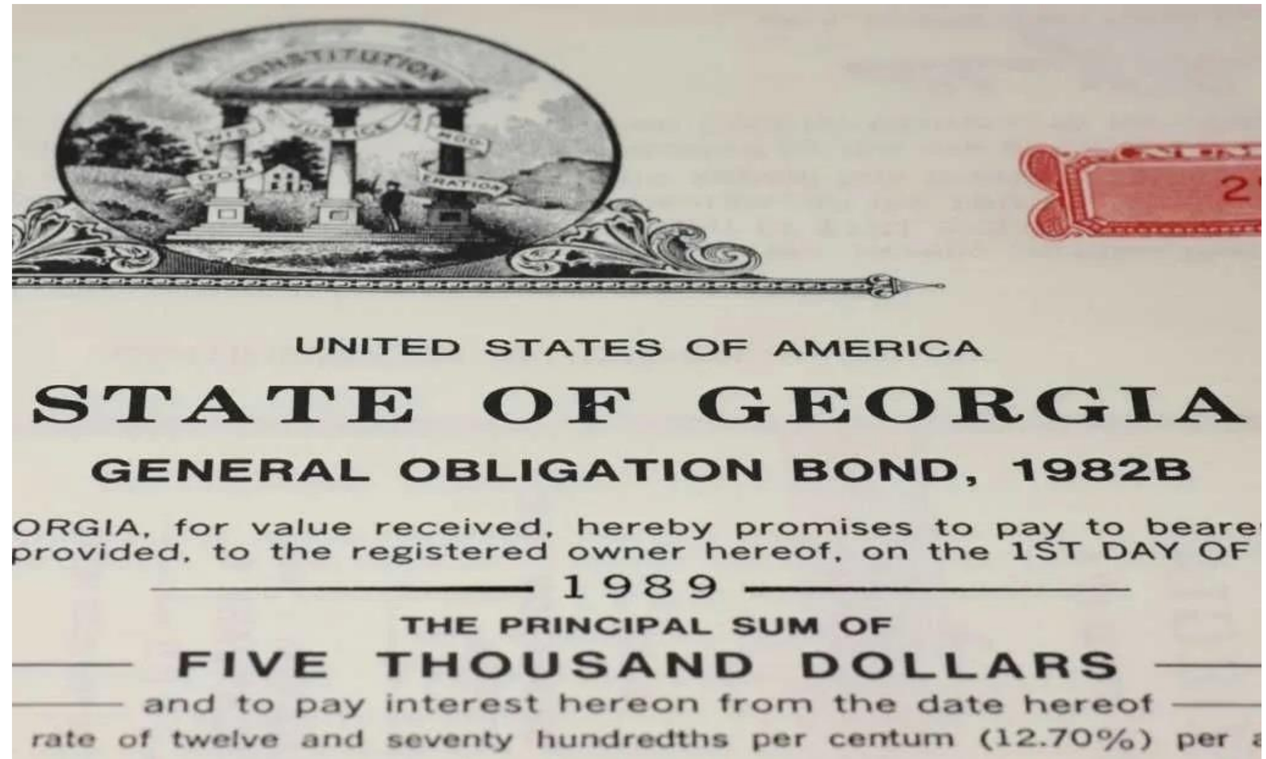
9. How bonds are priced, explain the bond pricing in detail.

What is Bond Pricing?

Bond pricing is an empirical matter in the field of financial instruments. The price of a bond depends on several characteristics inherent in every bond issued. These characteristics are:

- ✓ Coupon, or lack thereof
- ✓ Principal/par value
- ✓ Yield to maturity
- ✓ Periods to maturity

Alternatively, if the bond price and all but one of the characteristics are known, the last missing characteristic can be solved for.



Bond Pricing: Coupons

A bond may or may not come with attached coupons. A coupon is stated as a nominal percentage of the par value (principal amount) of the bond. Each coupon is redeemable per period for that percentage. For example, a 10% coupon on a $1000 par bond is redeemable each period.

A bond may also come with no coupon. In this case, the bond is known as a zero-coupon bond. Zero-coupon bonds are typically priced lower than bonds with coupons.

Bond Pricing: Principal/Par Value

Each bond must come with a par value that is repaid at maturity. Without the principal value, a bond would have no use. The principal value is to be repaid to the lender (the bond purchaser) by the borrower (the bond issuer). A zero-coupon bond pays no coupons but will guarantee the principal at maturity. Purchasers of zero-coupon bonds earn interest by the bond being sold at a discount to its par value.

A coupon-bearing bond pays coupons each period, and a coupon plus principal at maturity. The price of a bond comprises all these payments discounted at the yield to maturity.

Bond Pricing: Yield to Maturity

Bonds are priced to yield a certain return to investors. A bond that sells at a premium (where price is above par value) will have a yield to maturity that is lower than the coupon rate. Alternatively, the causality of the relationship between yield to maturity and price may be reversed. A bond could be sold at a higher price if the intended yield (market interest rate) is lower than the coupon rate. This is because the bondholder will receive coupon payments that are higher than the market interest rate, and will, therefore, pay a premium for the difference.

Bond Pricing: Periods to Maturity

Bonds will have a number of periods to maturity. These are typically annual periods, but may also be semi-annual or quarterly. The number of periods will equal the number of coupon payments.

The Time Value of Money

Bonds are priced based on the time value of money. Each payment is discounted to the current time based on the yield to maturity (market interest rate). The price of a bond is usually found by:

$$P(T0) = [PMT(T1) / (1 + r)^1] + [PMT(T2) / (1 + r)^2] \dots [(PMT(Tn) + FV) / (1 + r)^n]$$

Where:

- ✓ P(T0) = Price at Time 0
- ✓ PMT(Tn) = Coupon Payment at Time N

- ✓ FV = Future Value, Par Value, Principal Value
- ✓ R = Yield to Maturity, Market Interest Rates
- ✓ N = Number of Periods

Bond Pricing: Main Characteristics

Ceteris paribus, all else held equal:

- ✓ A bond with a higher coupon rate will be priced higher
- ✓ A bond with a higher par value will be priced higher
- ✓ A bond with a higher number of periods to maturity will be priced higher
- ✓ A bond with a higher yield to maturity or market rates will be priced lower

An easier way to remember this is that bonds will be priced higher for all characteristics, except for yield to maturity. A higher yield to maturity results in lower bond pricing.

Bond Pricing: Other "Soft" Characteristics

The empirical characteristics outlined above affect bond issues, especially in the primary market. There are other, however, bond characteristics that can affect bond pricing, especially in the secondary markets. These are:

- ✓ Creditworthiness of issuing firm
- ✓ Liquidity of bond trade
- ✓ Time to next payment

Firm Creditworthiness

Bonds are rated based on the creditworthiness of the issuing firm. These ratings range from AAA to D. Bonds rated higher than A are typically known as investment-grade bonds, whereas anything lower is colloquially known as junk bonds.

Junk bonds will require a higher yield to maturity to compensate for their higher credit risk. Because of this, junk bonds trade at a lower price than investment-grade bonds.

Bond Liquidity

Bonds that are more widely traded will be more valuable than bonds that are sparsely traded. Intuitively, an investor will be wary of purchasing a bond that would be harder to sell afterward. This drives prices of illiquid bonds down.

Time to Payment

Finally, time to the next coupon payment affects the "actual" price of a bond. This is a more complex bond pricing theory, known as 'dirty' pricing. Dirty pricing takes into account the interest that accrues between coupon payments. As the payments get closer, a bondholder has to wait less time before

receiving his next payment. This drives prices steadily higher before it drops again right after coupon payment.

10. Discuss briefly about Forex markets and the types of forex transactions.

- ✓ The foreign exchange market (forex, FX, or Currency Market) is a global decentralized market for the trading of currencies.
- ✓ The foreign exchange market determines the relative values of different currencies.
- ✓ Electronic Broking Services (EBS) and Reuters 3000 extra are two main interbank FX trading platforms.
- ✓ The forex market is the largest, most liquid market in the world, with trillions of dollars changing hands every day. It has no centralized location, and no government authority oversees it.
- ✓ Rather, the forex is an electronic network of banks, brokerages, institutional investors, and individual traders (mostly trading through brokerages or banks).
- ✓ The Forex market determines the day-to-day value, or the exchange rate, of most of the world's currencies.
- ✓ If a traveller exchanges dollars for euros at an exchange kiosk or a bank, the number of euros will be based on the current forex rate. If imported French cheese suddenly costs more at the grocery, it may well mean that euros have increased in value against the U.S. dollar in forex trading.
- ✓ Forex traders seek to profit from the continual fluctuations of currency values. For example, a trader may anticipate that the British pound will strengthen in value. The trader will exchange U.S. dollars for British pounds. If the pound then strengthens, the trader can do the transaction in reverse, getting more dollars for the pounds.

Main participants in Forex market:

a) Larger international banks.

   - ✓ Financial centers around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock, with the exception of weekends.
   - ✓ Banks turn to a smaller number of financial firms known as "dealers," who are actively involved in large quantities of foreign exchange trading.

b) Interbank market, which is made up of the largest commercial banks and securities dealers.

c) Smaller banks

d) Large MNC's

e) Commercial Companies

f) Central Banks

g) Hedge Funds as Speculators

h) Investment Management Firms

i) Retail Foreign Exchange Traders

j) Non-Bank Foreign Exchange Companies

k) Money Transfer/Remittance Companies and Bureaux De Change

Characteristics Forex Market

- ✓ Huge trading volume representing the largest asset class in the world leading to high liquidity
- ✓ Geographical dispersion
- ✓ Continuous operation: 24 hours a day except weekends, i.e., trading from 20:15 GMT on Sunday until 22:00 GMT Friday
- ✓ Variety of factors that affect exchange rates
- ✓ The low margins of relative profit compared with other markets of fixed income
- ✓ The use of leverage to enhance profit and loss margins and with respect to account size.

Currency Pairs

In forex trading, currencies are listed in pairs, such as USD/CAD, EUR/USD, or USD/JPY. These represent the U.S. dollar (USD) versus the Canadian dollar (CAD), the euro (EUR) versus the USD, and the USD versus the Japanese yen (JPY).

There will also be a price associated with each pair, such as 1.2569. If this is the USD/CAD pair, it means that it costs 1.2569 CAD to buy one USD. If the price increases to 1.3336, then it now costs 1.3336 CAD to buy one USD. The USD has increased in value against the CAD, so it now costs more CAD to buy one USD.

In the forex market, currencies trade in lots, called micro, mini, and standard lots. A micro lot is 1,000 worth of a given currency, a mini lot is 10,000, and a standard lot is 100,000. Trades take place in set blocks of currency. For example, a trader can exchange seven micro lots (7,000), three mini lots (30,000), or 75 standard lots (7,500,000).

Trading volume in the forex market is generally very large. Trading in the foreign exchange markets averaged $6.6 trillion worth per day in April 2019, according to the Bank for International Settlements.

- ✓ The largest trading centers are London, New York, Singapore, Hong Kong, and Tokyo.

Trading in the Foreign Exchange Market

- ✓ The Forex market is open 24 hours a day, five days a week around the globe.
- ✓ Historically, foreign exchange market participation was for governments, large companies, and hedge funds. In today's world, trading currencies is as easy as a click of a mouse and accessibility is not an issue. Many investment companies allow individuals to open accounts and trade currencies through their platforms.
- ✓ This is not like a trip to a foreign exchange kiosk. The process is entirely electronic with no physical exchange of money from one hand to another.
- ✓ Rather, traders are taking a position in a specific currency in the hope that there will be some upward movement and strength in the currency that they're buying (or weakness if they're selling) so that they can make a profit.

Forex Market vs. Other Markets

There are some fundamental differences between foreign exchange and other markets.

First of all, there are fewer rules, which means investors aren't held to strict standards or regulations like those in the stock, futures, and options markets. There are no clearing houses and no central bodies that oversee the forex market.

Second, since trades don't take place on a traditional exchange, there are fewer fees or commissions like those on other markets.

Next, there's no cut-off as to when you can and cannot trade. Because the market is open 24 hours a day, you can trade at any time.

Finally, because it's such a liquid market, you can get in and out whenever you want and you can buy as much currency as you can afford.

Types of Forex Transactions

Forex traders transact in one of three distinct marketplaces: the spot, the forward, or the futures market.

- ✓ The Forex Spot Market

The spot market is the most straightforward of the Forex markets. The spot rate is the current exchange rate. A transaction in the spot market is an agreement to trade one currency for another currency at the prevailing spot rate.

Spot transactions for most currencies are finalized in two business days. The major exception is the U.S. dollar versus the Canadian dollar, which settles on the next business day.

The price is established on the trade date, but money is exchanged on the value date.

Role of the U.S. Dollar

The U.S. dollar is the most actively traded currency.

The most common pairs are the USD versus the euro, Japanese yen, British pound, and Australian dollar.

Trading pairs that do not include the dollar are referred to as crosses. The most common crosses are the euro versus the pound and the euro versus the yen.

The spot market can be very volatile. Movement in the short term is dominated by technical trading, which bases trading decisions on a currency's direction and speed of movement. Longer-term changes in a currency's value are driven by fundamental factors such as a nation's interest rates and economic growth.

- ✓ The Forex Forward Market

A forward trade is any trade that settles further in the future than a spot transaction. The forward price is a combination of the spot rate plus or minus forward points that represent the interest rate differential between the two currencies.

Most forward trades have a maturity of less than a year in the future but a longer term is possible. As in the spot market, the price is set on the transaction date but money is exchanged on the maturity date.

A forward contract is tailor-made to the requirements of the counterparties. They can be for any amount and settle on any date that is not a weekend or holiday in one of the countries.

- ✓ Forex Futures

Unlike the rest of the foreign exchange market, forex futures are traded on an established exchange, primarily the Chicago Mercantile Exchange.

Forex futures are derivative contracts in which a buyer and a seller agree to a transaction at a set date and price.

This type of transaction is often used by companies that do much of their business abroad and therefore want to hedge against a severe hit from currency fluctuations. It also is subject to speculative trading.

Example of a Forex Trade

A trader thinks that the European Central Bank (ECB) will be easing its monetary policy in the coming months as the Eurozone's economy slows. As a result, the trader bets that the euro will fall against the U.S. dollar and sells short €100,000 at an exchange rate of 1.15. Over the next several weeks the

ECB signals that it may indeed ease its monetary policy. That causes the exchange rate for the euro to fall to 1.10 versus the dollar. This creates a profit for the trader of $5,000.

By shorting €100,000, the trader took in $115,000 for the short sale. When the euro fell, and the trader covered the short, it cost the trader only $110,000 to repurchase the currency. The difference between the money received on the short sale and the buy to cover it is the profit.

Had the euro strengthened versus the dollar, it would have resulted in a loss.

Pros and Cons of Forex

Pros

- ✓ The forex was once the exclusive province of banks and other financial institutions. The internet has blasted the doors wide open.
- ✓ Entry costs are low and the marketplace is open around the clock. There are many choices of forex trading platforms, including some that cater to beginners. There also are online forex trading courses that teach the basics.

Cons

- ✓ Those financial institutions and the traders who work for them are still there, alongside the neophytes working from home. They have deep pockets, sophisticated software that tracks currency price movements, and teams of analysts to examine the economic factors that make currency rates move.
- ✓ Currency trading is a fast-moving, volatile arena. It's risky business and can be made riskier by the use of leverage to increase the size of bets.
- ✓ It's an easy way to lose money fast. Anyone willing to jump into the Forex should get the necessary training in advance, and start slowly with a minimal stake.

Forex Terms

There are a number of terms that are used by Forex traders. Here are some of the basics.

- ✓ Going long: Buying a currency on the belief that its value will increase in a matter of hours. Then it can be sold for a profit.
- ✓ Going short: Selling a currency on the belief that its value will decrease. It can then be repurchased at a lower price.
- ✓ Currency pair: Every Forex transaction is an exchange of one currency for another. A currency pair quote looks like this: USD/GBP = $1.15. In this example, the U.S. dollar is the base currency, and the British pound is the quote currency. A trader who wishes to buy British pounds will pay $1.15 for each.

- ✓ The ask: The price the trader will pay to buy a currency pair.
- ✓ The bid: The price the trader will pay to sell a currency pair.
- ✓ The spread: The difference between the buying price and the selling price.

Major Currency Codes on the Forex

Just seven currency pairs represent the majority of trades on the Forex. They are:

- ✓ EUR/USD (Euro/U.S. dollar)
- ✓ USD/JPY (U.S. dollar/Japanese yen)
- ✓ GBP/USD (British pound/U.S. dollar)
- ✓ AUD/USD (Australian dollar/U.S. dollar)
- ✓ USD/CAD (U.S. dollar/Canadian dollar)
- ✓ USD/CHF (U.S. dollar/Swiss franc)
- ✓ NZD/USD (New Zealand dollar/U.S. dollar)

How Big Is the Forex Market?

The daily trading volume on the forex market dwarfs that of the stock and bond markets.

According to the latest triennial survey conducted by the Bank for International Settlements (BIS), trading in foreign exchange markets averaged $6.6 trillion per day in 2019.

By contrast, the total notional value of U.S. equity markets on Dec. 31, 2021, was approximately $393 billion.

What Is Foreign Exchange Trading?

When you're making trades in the forex market, you're buying the currency of one nation and simultaneously selling the currency of another nation.

There's no physical exchange of money. Traders are taking a position in a specific currency, with the hope that it will gain in value relative to the other currency.

How Does the Forex Market Differ from Other Markets?

- ✓ The Forex is a decentralized market. It has no physical existence and no owner or management.
- ✓ There are no clearing houses or central bodies to oversee the forex. That means traders aren't held to strict standards or regulations, as are seen in the stock, futures, or options markets.

✓ It also means there are fewer fees and commissions to pay.

11. Explain the exchange rates theory in forex market.

For the determination of the par values of different currencies, alternative theoretical explanations have been given.

Some of the prominent explanations or theories include:

1) Mint Parity Theory
2) The Purchasing Power Parity Theory
3) The Balance of Payments Theory

1) The Mint Parity Theory:

The earliest theory of foreign exchange has been the mint parity theory. This theory was applicable for those countries which had the same metallic standard (gold or silver). Under the gold standard, countries had their standard currency unit either of gold or it was freely convertible into gold of a given purity.

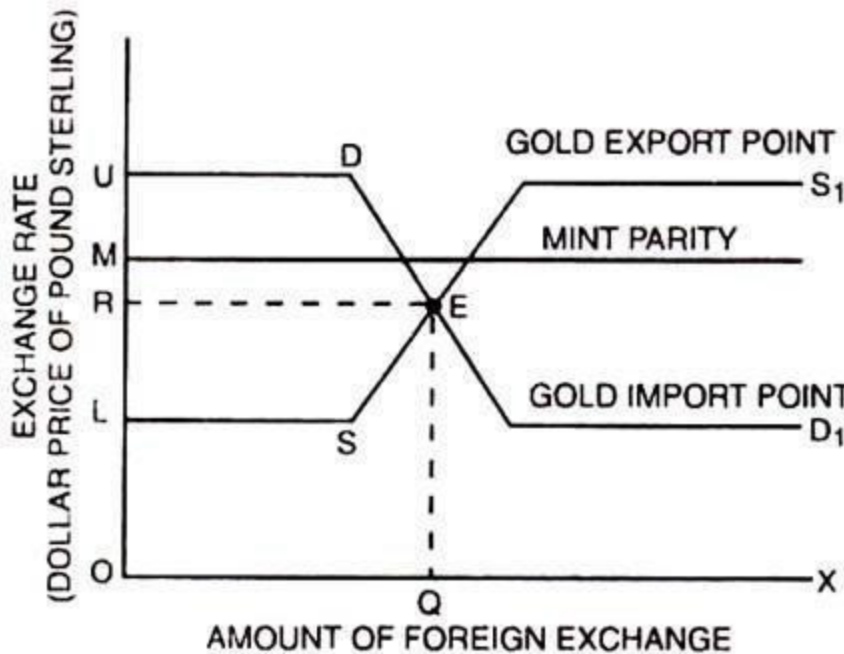
In order to illustrate it, the supposition is taken that the U.S. has a BOP deficit with Britain. It is adjusted through the export of gold to Britain. The mint parity between pound and dollar is £ 1 = $ 4. The cost of exporting gold including freight, insurance, packing, interest etc. of gold worth $ 4 is 0.04 dollar. So the U.S. importers have to pay 4.04 dollars (4+.04) for each pound.

No U.S. importer will pay more than 4.04 dollars for one British pound because he can buy 4 dollar worth of gold from the U.S. treasury and transport it to Britain and obtain 1 pound in exchange of that.

Therefore, the exchange rate between dollar and pound at the maximum can be £ 1 = $ 4.04. This exchange rate signifies U.S. gold export point or upper specie point. Similarly, the exchange rate of pound could not fall below $ 3.96 dollars, in case the United States had a BOP surplus resulting in flow of gold from Britain to that country.

If the rate of exchange were lower than £ 1 = $ 3.96, the exporter would have preferred to import gold from Britain. This rate of exchange (£ 1 = $ 3.96) is the U.S. gold import point or lower specie point. The upper and lower specie points prescribe the limits within which the fluctuation can take place in the market rate of exchange.

The determination of the rate of exchange, according to mint parity theory, can be explained through below Fig.



In above Fig, the amount of foreign exchange is measured along the horizontal scale and the exchange rate is measured along the vertical scale. DD1 and SS1 are the demand and supply curves of foreign exchange. The equilibrium market rate of exchange between dollar and pound sterling is determined by the intersection of DD1 and SS1 curves at E.

The equilibrium rate of exchange is OR at which the quantity of foreign exchange demanded and supplied is OQ. The horizontal line drawn at M denotes mint-parity (£ 1 = $ 4). The mint parity and market rate of exchange do not necessarily coincide.

The horizontal lines drawn at U and L denote the gold export point or upper specie point and gold import point or lower specie point respectively. The horizontal portion S1 of the supply curve SS1 corresponds with the upper specie point.

It indicates that no American would pay more than $ 4.04 for each pound. He can get any quantity of pounds at the price of $ 4.04 by exporting gold so that the supply function becomes horizontal or perfectly elastic at the upper specie point. D1 part of the demand function DD1 is again horizontal and it corresponds with the lower specie point L.

At the exchange rate £ 1 = $ 3.96, there can be an unlimited demand for pounds by the Americans so that the demand curve becomes perfectly elastic at the lower specie point. If the rate of exchange falls below the lower specie point, the U.S. will prefer to import gold from Britain. It, therefore, lies down that the rate of exchange can lie only within the limits of the upper and lower specie points or within the gold-export and gold-import points.

The mint parity theory of foreign exchange rate highlighted two important facts. Firstly, the actual rate of exchange can differ from the equilibrium rate of exchange. Secondly, under gold standard, there are specified limits beyond which the fluctuations in the rate of exchange cannot take place.

The mint parity theory was severely criticized on the various grounds. Firstly, the international gold standard has been completely abandoned since its breakdown under the weight of depression of 1930's. It is, therefore, unrealistic to analyse the rate of exchange presently in terms of mint parities. Secondly, the theory presupposed the free international gold movements.

The modern governments do not permit the free buying and selling of gold internationally. In these circumstances, the mint parity theory of exchange rate has little relevance. Thirdly, most of the countries at present are having inconvertible paper currencies. In such a system, the mint parity theory cannot at all determine the rate of exchange.

In view of the above shortcomings, the traditional mint-parity theory does not have any practical significance in the field of determination of foreign exchange rate. It is absolutely not more than an academic exercise in the modern times.

2) The Purchasing Power Parity Theory:

The purchasing power parity theory enunciates the determination of the rate of exchange between two inconvertible paper currencies. Although this theory can be traced back to Wheatley and Ricardo, yet the credit for developing it in a systematic way has gone to the Swedish economist Gustav Cassel.

This theory states that the equilibrium rate of exchange is determined by the equality of the purchasing power of two inconvertible paper currencies. It implies that the rate of exchange between two inconvertible paper currencies is determined by the internal price levels in two countries.

There are two versions of the purchasing power parity theory:

(i) The Absolute Version and

(ii) The Relative Version.

(i) The Absolute Version:

According to this version of the purchasing power parity theory, the rate of exchange should normally reflect the relation between the internal purchasing power of the different national currency units. In other words, the rate of exchange equals the ratio of outlay required to buy a

particular set of goods at home as compared with what it would buy in a foreign country. It may be illustrated with an example.

Suppose 10 units of commodity X, 12 units of commodity Y and 15 units of commodity Z can be bought through spending Rs. 1500 and the same quantities of X, Y and Z commodities can be bought in the United States at an outlay of 25 dollars. It signifies that the purchasing power of 25 dollars is equivalent to that of Rs. 1500 in their respective countries. That can form the basis for determining the rate of exchange between rupee and dollar.

The exchange rate between them can be expressed as:

$$\$25 = \text{Rs. } 1500$$

$$\$1 = \text{Rs. } 60$$

It is possible to measure the rate of exchange between the currencies A and B as below :

Rate of Exchange (R) =

$$\frac{\text{Units of Currency A}}{\text{Units of Currency B}} \times \frac{\text{Internal Purchasing Power of A}}{\text{Internal Purchasing Power of B}}$$

Since the internal purchasing power of each currency is the reciprocal of the general price index in those respective countries, the above expression can be restated as

$$R = \frac{\text{Units of Currency A}}{\text{Units of Currency B}} \times \frac{\text{Price Index in Country B}}{\text{Price Index in Country A}}$$

Since units of currency in two countries buy equal sets of commodities (Q_0), R can be expressed as

$$R = \frac{Q_0}{Q_0} \times \frac{P_B}{P_A}$$

Here P_B and P_A are the price index numbers in countries B and A respectively.

If $Q_0 = 100$, $P_B = 180$ and $P_A = 150$, then

$$R = \frac{Q_0}{Q_0} . \times . \frac{P_B}{A_A} = \frac{100}{100} \times \frac{180}{150} = \frac{6}{5} = 1.20$$

R : 1 Unit of Currency A = 1.20 Units of Currency B

The absolute version of the purchasing power parity theory is, no doubt, quite simple and elegant, yet it has certain shortcomings. Firstly, this version of determining exchange rate is of little use as it attempts to measure the value of money (or purchasing power) in absolute terms. In fact, the purchasing power is measured in relative terms. Secondly, there are differences in the kinds and qualities of products in the two countries.

These diversities create serious problem in the equalisation of product prices in different countries. Thirdly, apart from the differences in quality and kind of goods there are also differences in the pattern of demand, technology, transport costs, tariff structures, tax policies, extent of state intervention and control and several other factors. These differences prohibit the measurement of exchange rate in two or more currencies in strict absolute terms.

(ii) The Relative Version:

The relative version of Cassel's purchasing power parity theory attempts to explain the changes in the equilibrium rate of exchange between two currencies. It relates the changes in the equilibrium rate of exchange to changes in the purchasing power parities of currencies. In other words, the relative changes in the price levels in two countries between some base period and current period have vital bearing upon the exchange rates of currencies in the two periods.

According to this version, the equilibrium rate of exchange in the current period (R1) is determined by the equilibrium rate of exchange in the base period (R1) and the ratio of price indices of current and base period in one country to the ratio of price indices of current and base periods in the other country.

$$R_1 = R_0 . \frac{P_{B_1}/P_{B_0}}{P_{A_1}/P_{A_0}}$$

In the above expression, R1 is the rate of exchange in the current period and R0 is the rate of exchange in the base period or the original rate of exchange. PB1 and PB0 are the price indices in country B in the current and base periods respectively. PA1 and PA0 are the price indices in the current and base periods respectively in the country A.

To illustrate, it is supposed that the original or base period rate of exchange between rupee and dollar was $ 1 = Rs. 50. The price index in India (country B) in the current period (PB1) is 180 and the price index in the U.S.A. (country A) in the current period is 150. The price indices of two countries in the base period were 100.

$$R_0 = 50/1,\ P_{A_1} = 150,\ P_{B_1} = 180,\ P_{A_0} = 100,\ P_{B_0} = 100$$

$$\text{Now} \quad R_1 = R_0 \frac{P_{B_1}/P_{B_0}}{P_{A_1}/P_{A_0}} = \frac{50}{1} \times \frac{180}{150} \times \frac{100}{100}$$

$$= \frac{50}{1} \times \frac{180}{100} \times \frac{100}{150} = 60$$

$$R_1 : \$ 1 = \text{Rs. } 60.00$$

It shows that rupee has depreciated while dollar has appreciated between the two periods.

If the price level in India (B) has risen between the two periods at a relatively lesser rate than in the U.S.A., the exchange rate of rupee with dollar will appreciate. The dollar on the opposite will show some depreciation.

It is illustrated through the following hypothetical example:

$$R_0 = 50/1,\ P_{A_1} = 176,\ P_{B_1} = 154,\ P_{A_0} = 100,\ P_{B_0} = 100$$

$$\text{Now} \quad R_1 = R_0 . \frac{P_{B_1}/P_{B_0}}{P_{A_1}/P_{A_0}} = \frac{48}{1} \times \frac{154/100}{176/100}$$

$$= \frac{48}{1} \times \frac{154}{100} \times \frac{100}{176} = 42$$

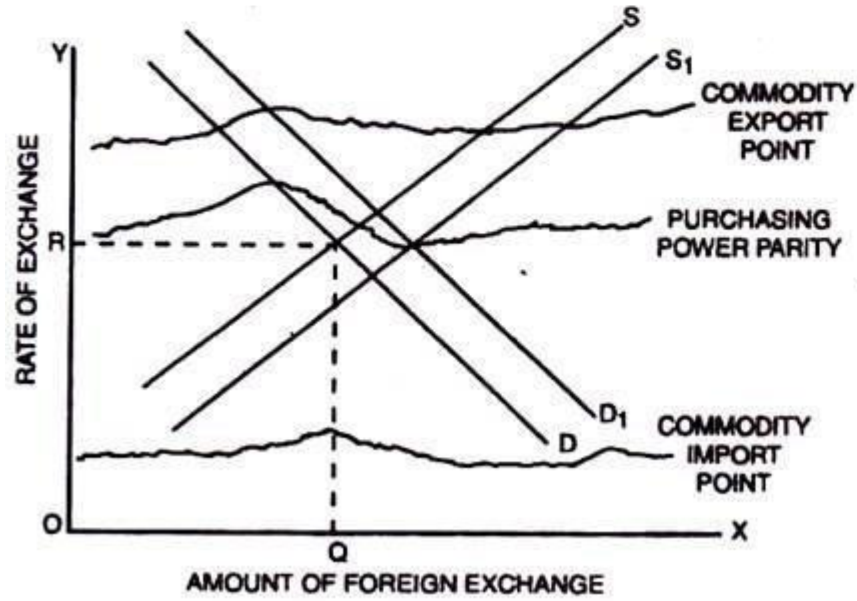
$$\therefore \quad R_1 : \$ 1 = \text{Rs. } 42$$

Thus rupee has appreciated while the dollar has depreciated between the two time periods.

It is, of course, true that the purchasing power parity between the two currencies is determined by the quotient of their respective purchasing power. This parity is modified by the cost of transportation including freights, insurance and other charges. These costs lay down the limits within which the rate of exchange will fluctuate.

The upper limit is called as the commodity export point whereas the lower limit is termed as the commodity import point. These limits are not fixed as the gold specie points. Since the purchasing power parity itself is a moving parity on account of the price variations in the two countries, the limits within which it fluctuates are also of a moving character.

The purchasing power parity theory is explained through below Fig.



In above Fig, the purchasing power parity curve is of a fluctuating character. It signifies a moving parity. Along with it, the curves indicating commodity export and commodity import points also fluctuate. The market rate of exchange is determined by the intersection of demand curve DD and supply curve SS of foreign exchange.

The market rate of exchange is OR and the quantity of foreign exchange demanded and supplied is OQ. When the demand for and supply of foreign exchange change, the demand and supply curves can undergo shifts as shown by D1 and S1 curves.

Accordingly, there will be variations in the market rate of exchange around the normal rate of exchange determined by the purchasing power parity. The market rate of exchange, however, will invariably lie between the limits specified by the commodity export and commodity import points.

3) The Balance of Payments Theory:

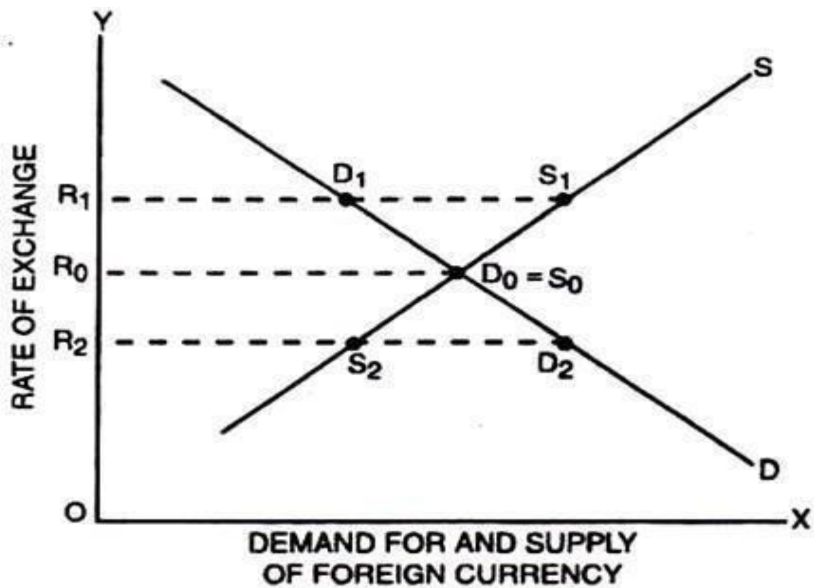
The balance of payments theory of exchange rate maintains that rate of exchange of the currency of one country with the other is determined by the factors which are autonomous of internal price level and money supply. It emphasizes that the rate of exchange is influenced, in a significant way, by the balance of payments position of a country.

A deficit in the balance of payments of a country signifies a situation in which the demand for foreign exchange (currency) exceeds the supply of it at a given rate of exchange. The demand for foreign exchange arises from the demand for foreign goods and services. The supply of foreign exchange, on the contrary, arises from the supply of goods and services by the home country to the foreign country.

In other words, the excess of demand for foreign exchange over the supply of foreign exchange is coincidental to the BOP deficit. The demand pressure results in an appreciation in the exchange value of foreign currency. As a consequence, the exchange rate of home currency to the foreign currency undergoes depreciation.

A balance of payments surplus signifies an excess of the supply of foreign currency over the demand for it. In such a situation, there is a depreciation of foreign currency but an appreciation of the currency of the home country.

The equilibrium rate of exchange is determined, when there is neither a BOP deficit nor a surplus. In other words, the equilibrium rate of exchange corresponds with the BOP equilibrium of a country. The determination of equilibrium rate of exchange can be shown through below Fig.



In above Fig, the demand for and supply of foreign exchange are measured along the horizontal scale and rate of exchange is measured along the vertical scale. D is the negatively sloping demand function of foreign currency. S is the positively sloping supply function of foreign currency. The equilibrium rate of exchange is OR0 which is determined by the intersection between the demand and supply functions of foreign currency where D0R0 = S0R0.

The equality between the demand for and supply of foreign exchange signifies also the BOP equilibrium of the home country. If the rate of exchange is OR1 which is higher than the equilibrium rate of exchange OR0, the demand for foreign currency D1R1 falls short of the supply of foreign currency S1R1. In this situation, the home country has a BOP surplus.

The excess supply of foreign exchange lowers the exchange value of foreign currency relative to home currency. The appreciation in the exchange rate of home currency reduces exports and raises imports. In this way, the BOP surplus gets reduced and the system tends towards the BOP equilibrium and also the equilibrium rate of exchange.

If the rate of exchange is OR2 which is lower than the equilibrium rate of exchange OR0, the demand for foreign currency D2R2 exceeds the supply of foreign currency S2R2. The excess demand of foreign currency D2S2 signifies the BOP deficit. As a result of the excess demand for foreign currency, the exchange value of foreign currency appreciates while the home currency depreciates.

The depreciation of the exchange value of home currency leads to a rise in exports and a decline in imports. Thus the BOP deficit gets reduced and the exchange rate appreciates to approach finally the equilibrium rate of exchange OR0 where the BOP is also in a state of equilibrium.

If there are changes in demand or supply or both, the rate of exchange will be accordingly influenced. Apart from the changes in demand and supply, the rate of exchange is affected by the foreign elasticity of demand for exports, the domestic elasticity of demand for imports, the domestic elasticity of supply of exports and the foreign elasticity of supply of imports. The stability of the equilibrium rate of exchange requires that the demand elasticities should be high whereas the supply elasticities should be low.

12. Explain Forex risk exposures and basics of corporate forex risk management.

What is Foreign Exchange Risk?

Foreign exchange risk is the chance that a company will lose money on international trade because of currency fluctuations. Also known as currency risk, FX risk and exchange rate risk, it describes the possibility that an investment's value may decrease due to changes in the relative value of the involved currencies. It affects investors and any business involved in international trade.

The risk occurs when a contract between two parties specifies exact prices for goods or services as well as delivery dates. If a currency's value fluctuates between the date the contract is signed and the delivery date, a loss for one of the parties could result.

Types of Foreign Exchange Risk

There are three main types of foreign exchange risk, also known as foreign exchange exposure: transaction risk, translation risk, and economic risk. A fourth – jurisdiction risk – arises when laws unexpectedly change in the country where the exporter is doing business. This is less common and exists primarily in unstable countries.

Transaction Risk

Occurs when a company buys products from a supplier in another country, and price is provided in the supplier's currency. If the supplier's currency appreciates vs. the buyer's currency, the buyer will have to pay more in its base currency to meet the contracted price.

The risk of transaction exposure typically impacts one side of a transaction: the business that completes the transaction in a foreign currency. The company receiving or paying a bill using its home currency is not subjected to the same risk.

While a high level of exposure to exchange rates can lead to major losses, savvy finance professionals hedge or mitigate those risks.

Translation Risk

Refers to how a foreign exchange transaction will impact financial reporting; i.e., the risk that a company's equities, assets, liabilities or income will change in value as a result of exchange rate changes.

This risk occurs because subsidiaries of a parent company in another country denominate their currency in the countries where they are located. The parent company faces potential losses when it must translate the subsidiaries' financial statements into its own country's currency.

Economic Risk

Also known as operating exposure, this refers to the impact on a company's market value from exposure to unexpected currency fluctuations. This can affect a company's future cash flows, foreign investments and earnings.

Economic exposure can have a substantial impact on a company's market value:

- ✓ Exposure is greater for multinational companies with many overseas subsidiaries and a large

number of transactions involving foreign currencies.

- ✓ Globalization has increased economic exposure for all companies.
- ✓ Effects are far-reaching and long-term in nature.
- ✓ Economic exposure is difficult to measure precisely.
- ✓ Because of this, hedging against economic exposure can be challenging as it deals with unexpected changes in foreign exchange rates. However, there are way to mitigate this risk.

Examples of Foreign Exchange Risk

How you exchange foreign currency can affect the results from expanding your business globally. Here are two examples.

1. An American equipment distributor agrees to buy 100 cases of equipment from a Spanish supplier at 500 euros per case, or 50,000 euros total, with payment due upon delivery.

  - ✓ The U.S. dollar and Euro are at parity: $1 = 1 Euro
  - ✓ The American company expects to pay the agreed-upon amount of 50,000 euros upon delivery, when value of the purchase was $50,000
  - ✓ Due to production problems, delivery is delayed three months, and the value of the U.S. dollar depreciates against the Euro during that time, so 1 euro now equals $1.10.
  - ✓ The contracted price remains 50,000 Euro, but the dollar amount that the U.S. company must pay is $55,000.

2. A U.S.-based company intends to purchase a product from a supplier in England.

  - ✓ The American company agrees to negotiate the deal when the pound/dollar exchange rate is at a 1-to-1.3 ratio (1 pound = $1.30).
  - ✓ Once the agreement is complete, the sale could take place in days, weeks, or months. During that time, the exchange rate may change, for better or worse to the American company.
  - ✓ When the sale is completed and payment due, the exchange rate ratio might have shifted to a more favorable 1-to-$1.25 rate or a less favorable 1-to-$1.40 rate.

In these examples, despite any change in value of the dollar relative to the euro or pound, neither the supplier in Spain or England would experience any transaction exposure because the deal took place in their local currencies. These companies are not affected if it costs the U.S. company more dollars to complete the transactions because the prices, as dictated by the sales agreements, were set in euros and pounds, respectively.

Ways to Mitigate Economic Exposure

- ✓ Operational Strategies

Diversify production facilities

End product markets

Financing sources

Hedging

- ✓ Currency Risk Mitigation

Risk-sharing agreement

Matching currency flows

Currency swaps

Use many different currencies

Foreign Exchange Trading

Yet another currency risk mitigation strategy is foreign exchange trading, where companies are trading in the currency of different countries. Also known as hedging, this financial strategy helps manage exposure and foreign exchange risk and financial loss. Hedging offsets, a potential loss from foreign exchange trading by taking an opposite position in a related currency.

Example: A U.S. company plans to buy products from France at a future date. The dollar and franc are equal, but the franc is expected to appreciate against the dollar.

Hedging strategy: The company buys francs at the current price, which is at parity with the dollar. It then makes its future purchases in francs.

Causes of Foreign Exchange Risk

Foreign exchange risk is caused by fluctuations in international currencies. There are several causes of these fluctuations

- ✓ Macroeconomic factors such as significant swings in exchange rates
- ✓ Government policies - Can result in a dip or hike in market movement. Changes in inflation, interest rates, import-export duties and taxes impact the exchange rate

- ✓ Sovereign risk: that a government is unable to repay its debt and defaults on its payments

Can have a direct impact on investment rates as repercussions can trigger other business-related troubles.

Includes political unrest and even a change in government policies, which can impact the exchange rate and, in turn, affect business transactions.

- ✓ Collapse of a foreign government
- ✓ Credit risk: that the counterparty will default in making the obligations it owes

Out of a seller's control as it depends on another party's commitment to pay its debts

Counterparty's business activities must be monitored so business transactions are closed at the right time without risk of default

Ways to Manage Foreign Exchange Risk

For U.S. companies, there are three ways to manage and mitigate foreign exchange risk.

- ✓ Establish a forward contract with a bank or foreign exchange service provider.

As the most direct and common method for managing foreign exchange risk, this option ensures that a U.S. exporter will receive a predetermined payment in U.S. dollars even if the rate fluctuates. To set one up, the exporter must know three things: the foreign currency amount; date the importer will pay, and the currency exchange delivery date.

Setting up a forward contract involves several steps:

i. Exporter agrees to accept payment in a different currency, such as euros.

ii. Exporter contacts a bank or foreign exchange service provider to negotiate a 60-day forward rate. (Fees for forward contracts, along with their rates and terms, vary.)

iii. Exporter and importer finalize sales price and payment terms with a commitment from the bank.

iv. Exporter then enters into a forward contract with its bank to lock in the rate and commit to a delivery date to exchange euros for U.S. dollars.

v. Finally, the importer pays the exporter on time.

vi. Exporter delivers the euros to its bank in exchange for U.S. dollars.

If the exporter is uncertain when the importer will pay, an alternative is to request a window forward contract with the bank or service provider. This gives the exporter a window of delivery between the two dates.

- ✓ The exporter accepts foreign currency payments only with cash in advance.

This option is ideal for small transactions as well as for new relationships with importers. It is simple, ensures full payment, and is most risk-free. But some importers may balk, as cash in advance is their least desirable method of payment.

- ✓ Match foreign currency receipts with expenditures.

Here, the exporter sets up a foreign currency bank account to conduct transactions and eliminate currency conversion fees. This is ideal for U.S. exporters that use the same foreign currency with different trading partners.

With this option, it's important to assess the cost and effort required to maintain a banking account in a foreign currency and record gains and losses resulting from currency conversions in financial statements. These can be fairly significant drawbacks.

Finally, before agreeing to an importer's foreign currency requests, you'll want to consult with a bank to learn:

i. When should an exporter consider selling in a foreign country?

ii. How common is it for a small exporter to set prices in a foreign currency?

iii. What type of transactions are most suitable for foreign exchange?

iv. What are the fees for using a forward contract?

UNIT V MUTUAL FUNDS, DERIVATIVES MARKETS AND VENTURE CAPITAL AND PRIVATE EQUITY

Mutual funds institutions in India. Types of mutual funds, Basics in portfolio management, Metrics of performance for fund manager

Introduction to Derivatives and the size of derivatives markets -Brief introduction to forwards, Options, Futures and Swaps. Role of VCs and PEs in financial markets - Venture capital and Private equity

PART – A

1. What is portfolio management?

Portfolio management is a process encompassing many activities of investment in assets and securities.

2. How 'portfolio manager' does call under SEBI?

According to SEBI, 'portfolio manager means any person who pursuant to a contract or arrangement with a client, advises or directs or undertakes on behalf of the client the management or administration of a portfolio of securities or the funds of the client.

3. Define mutual fund.

An investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets.

4. How does a mutual fund operate?

A mutual fund is a company that pools money from investors. It takes this money and invests it in a variety of stocks, bonds, and short term money market investments. Each fund has operating rules put in place to help define what sort of investments the fund can make. For example, a mutual fund that emphasizes buying bonds will not purchase many (or any) stocks.

5. List the services rendered by Portfolio Managers.

- ✓ Discretionary - Under these services, the choice as well as the timings of the investment decisions rest solely with the Portfolio Manager.
- ✓ Non-Discretionary -Under these services, the portfolio manager only suggests the investment ideas. The choice as well as the timings of the investment decisions rest solely with the Investor. However, the execution of trade is done by the portfolio manager.

- ✓ Advisory -Under these services, the portfolio manager only suggests the investment ideas. The choice as well as the execution of the investment decisions rest solely with the Investor.

6. What is derivative market?

Derivatives are contracts that gain their value from the value of financial variables. Financial variables used to trade derivatives are also known as underlying. They include commodity prices, interest rates, oil prices, prices of metals, equity indices, real estate indices, Cryptocurrencies, temperature changes, etc.

7. Define Option contract.

An option contract is an agreement between two parties to transact on underlying security at a predetermined price called the strike price before some date called the expiration date. The option gives the holder a right but not the obligation to buy/sell the underlying at an agreed-upon date at the strike price.

8. What is forward contract?

A forward contract is a non-standardized contract – traded in an over-the-counter market – between two parties that specifies the price and the quantity of an asset to be delivered in the future. That it's non-standardized implies it cannot be traded on an exchange. Instead, they are traded in the OTC market.

9. What is a future contract?

A futures contract is a standardized, legally binding agreement – traded in on an exchange – between two parties that specifies the price to trade a given asset (commodity or financial instrument) at a specified future date.

10. Define venture capital.

It is a long term capital invested in companies which involves high risk. The financing involves high risk but is compensated by high return

11. What are the various types of venture capital?

- ✓ VCFs promoted by the Central govt. controlled development financial institutions
- ✓ VCFs promoted by the state government-controlled development finance institutions
- ✓ VCFs promoted by Public Sector banks
- ✓ VCFs promoted by the foreign banks or private sector companies and financial institutions

12. Mention any two venture capital Industry of India.

- ✓ Helion Venture Partners.

- ✓ Accel Partners.
- ✓ Blume Ventures.
- ✓ Sequoia Capital India.
- ✓ Nexus Venture Partners.
- ✓ Inventus Capital Partners.
- ✓ IDG Ventures.

PART - B

1. Outline the procedure related to the registration of portfolio managers under the SEBI regulation 1993.

PORTFOLIO MANAGERS

Portfolio manager are defined as persons who in pursuance of a contract with clients, advise, direct, undertake on their behalf the management/ administration of portfolio

Registration of portfolio managers:

✓ Application for grant of certificate:

1. An application by a portfolio manager for grant of a certificate shall be made to the Board in Form A.
2. Not-withstanding anything contained in sub-regulation (1), any application made by a portfolio manager prior to coming into force of these regulations containing such particulars or as near thereto as mentioned in Form A shall be treated as an application made in pursuance of sub-regulation (1) and dealt with accordingly.

✓ Application to conform to the requirements:

Subject to the provisions of sub-regulation (2) of Regulation 3, any application, which is not complete in all respects and does not conform to the instructions specified in the form, shall be rejected:

Provided that before rejecting any such application, the applicant shall be given an opportunity to remove within the time specified such objections as may be indicated by the Board.

✓ Furnishing of further information, clarification, and personal representation:

1. The Board may require the applicant to furnish further information or clarification regarding matters relevant to his activity of a portfolio manager for the purposes of disposal of the

application.

2. The applicant or, its principal officer shall, if so required, appear before the Board for personal representation.

- ✓ Consideration of application:

1. For considering the grant of certificate of registration to the applicant, the Board shall take into account all matters which it deems relevant to the activities relating to portfolio management.

2. Without prejudice to the generality of the foregoing provisions, the Board shall consider whether -

a) The applicant is a body corporate;

b) The applicant has the necessary infrastructure like adequate office space, equipment's and the manpower to effectively discharge the activities of a portfolio manager;

c) The principal officer of the applicant has the professional qualifications in finance, law, accountancy or business management from an institution recognized by the Government;

d) The applicant has in its employment minimum of two persons who, between them, have at least five years' experience as portfolio manager or stock broker or investment manager or in the areas related to fund management;

e) Any previous application for grant of certificate made by any person directly or indirectly connected with the applicant has been rejected by the Board;

f) Any disciplinary action has been taken by the Board against a person directly or indirectly connected with the applicant under the Act or the Rules or the Regulations made there under;

g) Explanation - For the purposes of sub-clauses (e) and (f), the expression " person directly or indirectly connected" means any person being an associate, subsidiary, inter connected company or a company under the same management within the meaning of section 370(1B) of the Companies Act,1956 or in the same group;

h) The applicant fulfills the capital adequacy requirements specified in regulation 7;

i) The applicant, its director, principal officer or the employee as specified in clause (d) is involved in any litigation connected with the securities market which has an adverse bearing on the business of the applicant;

j) The applicant, its director, principal officer or the employee as specified in clause (d) has at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence;

k) The applicant is a fit and proper person;

l) Grant of certificate to the applicant is in the interests of investors.

- ✓ Capital Adequacy Requirement:

The capital adequacy requirement referred to in clause (g) of regulation 6 shall not be less than the net worth of fifty lacks rupees;

Explanation: For the purposes of this regulation, "net worth" means the aggregate value of paid up equity capital plus free reserves (excluding reserves created out of revaluation) reduced by the aggregate value of accumulated losses and deferred expenditure not written off, including miscellaneous expenses not written off.

Procedure for registration:

The Board on being satisfied that the applicant fulfils the requirements specified in Regulation 6 shall send intimation to the applicant and on receipt of the payment of fees as specified in Schedule II then grant a certificate in Form B.

- ✓ Renewal of certificate:

1. A portfolio manager may, three months before the expiry of the validity of the certificate, make an application for renewal in Form A.
2. The application for renewal, under sub-Regulation (1) shall be dealt with in the same manner as if it were an application for grant of a certificate made under Regulation 3.
3. The Board on being satisfied that the applicant fulfils the requirements specified in Regulation 6 for renewal of certificate shall grant a certificate in Form B and send intimation to the applicant.

Procedure where registration is not granted

- ✓ Where an application for grant of a certificate under Regulation 3 or of renewal under Regulation 9 does not satisfy the requirements set out in Regulation 6, the Board may reject the application, after giving an opportunity of being heard.
- ✓ The refusal to grant registration shall be communicated by the Board within thirty days of such refusal to the applicant stating therein the grounds on which the application has been rejected.
- ✓ Any applicant may, being aggrieved by the decision of the Board under sub-regulation (1), apply within a period of thirty days from the date of receipt of such intimation, to the Board for reconsideration of its decision.
- ✓ The Board shall reconsider an application made under sub- Regulation (3) and communicate its

decision as soon as possible in writing to the applicant.

Effect of refusal to grant certificate:

Any portfolio manager whose application for a certificate has been refused by the Board shall on and from the date of the receipt of the communication under sub-Regulation (2) of Regulation 10 cease to carry on any activity as portfolio manager.

Payment of fees, and the Consequences of failure to pay fees:

- ✓ Every applicant eligible for grant of a certificate shall pay fees in such manner and within the period specified in Schedule II.
- ✓ Where a portfolio manager fails to pay the fees as provided Schedule II, the Board may suspend the certificate, whereupon the Portfolio Manager shall forthwith cease to carry on the activity as a portfolio manager for the period during which the suspension subsists.

2. Explain functions, Strategies, and the General obligation of portfolio managers as enunciated by SEBI.

Functions of portfolio managers:

Risk Diversification:

An essential function of portfolio management is spread risk akin to investment of assets. Diversification could take place across different securities and across different industries. Is an effective way of diversifying the risk in an investment? Simple diversification reduces risk within categories of stocks that all have the same quality rating.

Asset Allocation:

An important function of portfolio management is asset allocation. It deals with attaining the operational proportions of investments from asset categories. Portfolio managers basically aim of stock-bond mix. For this purpose, equally weighted categories of assets are used.

Bets Estimation:

Another important function of a portfolio manager is to make an estimate of best coefficient. It measurers and ranks the systematic risk of different assets. Best coefficient is an index of the systematic risk. This is useful in making ultimate selection of securities for investment by investment by a portfolio manager.

E-Balancing Portfolios:

Rebalancing of portfolios involves the process of periodically adjusting the portfolios to maintain the original conditions of the portfolio. The adjustment may be made either by way of Constant proportion portfolio or by way of Constant best portfolio. In Constant proportion portfolio, adjustments are made in such a way as to maintain the relative weighing in portfolio components according to the change in prices. Under the constant beta portfolio, adjustments are made to accommodate the values of component betas in the portfolio.

Strategies of portfolio managers:

Buy and Hold Strategy Under the buy and hold ‘strategy, the portfolio manager builds a portfolio of stock which is not disturbed at all for a long period of time. This practice is common in the case of perpetual securities such as common stock.

Indexing Another strategy employed by portfolio managers is indexing. Indexing involves an attempt to replicate the investment characteristics of a popular measure of the bond market.

Securities that are held in best-known bond indexes are basically high grade issues.

Laddered Portfolio Under the laddered portfolio, bonds are selected in such a way as that their maturities are spread uniformly over a long period of time. This way a portfolio manager aims at distributing the funds throughout the yield curve.

Barbell Portfolio Under the laddered portfolio, bonds are selected in such a way as that their maturities are spread uniformly over a long period of time. This way a portfolio manager aims at distributing the funds throughout the yield curve can also benefit from lower transaction costs because of better liquidity.

General obligation of portfolio managers as enunciated by SEBI. Contract with client:

- ✓ Every portfolio manager before taking the assignment they should enter into the contract with the client clearly defining the interrelationship, mutual rights, liabilities and obligation relating to management of funds or portfolio of securities containing the details as specified in Schedule IV.
- ✓ The agreement between the portfolio manager and the client shall, inter alia, contain the following:
- ✓ The funds of all clients shall be placed by the portfolio manager in a separate account to be maintained by him in a scheduled commercial bank (any bank included in the Second Schedule to the Reserve bank of India Act, 1934 (2 f 1934)
- ✓ Notwithstanding and, thing contained in the agreement between a portfolio manager and his client referred to in regulation 14 hereof, the portfolio funds can be withdrawn or taken back by Portfolio client at his risk before the maturity date of the contract the following circumstances:

- ✓ Voluntary or compulsory, termination of Portfolio management services by the Portfolio manager;
- ✓ Suspension or termination of registration of Portfolio manager by the board.
- ✓ Bankruptcy or liquidation in case the portfolio manager is body corporate
- ✓ Permanent disability, lunacy or insolvency in case portfolio manager is an individual

Contents:

- ✓ Appointment of portfolio manager:
- ✓ Scope - services to be provided by the Portfolio Manager subject to the activities permitted under SEBI (Portfolio Managers) regulations, 1993, viz. advisory, investment, management, custody of securities and keeping t rack of corporate benefits associated with the securities. The portfolio Manager shall act in a fiduciary capacity and as a trustee and agent of the clients account.
- ✓ Function, obligations, duties and responsibilities (as discretionary and non- discretionary to be given separately) with specific provisions regarding instruction for nondiscretionary portfolio manager inter alia
  - a) Terms in compliance with the Act, SEBI (Portfolio Managers) Regulations, 1993, rules, regulations guidelines made under the Act and any other laws/rules/regulations/guidelines etc.
  - b) Providing reports to clients.
  - c) Maintenance of client-wide transactions and related books of accounts.
  - d) Provisions regarding Auditing accounts as required by SEBI
  - e) Settlement of accounts and procedure therefore, including the provisions for payment of maturity or early termination of contract.
- ✓ Investment objectives and guidelines such as following:
  - a) Types of securities in which investment would be made specifying restrictions, if any.
  - b) Particulars regarding amount, period of management, repayment or withdrawal
  - c) Taxation aspects such as Tax Deducted at Source, etc. if any.
  - d) Condition that the portfolio manager shall not lend the securities of the client unless authorized by him in writing.
- ✓ Risk factors:

A detailed statement of risks associated with each type of investment including the standard risks associated with each type of investment risk factors specific to the scheme as well as the attendant to special investment Policies and the objectives of the scheme are to be mentioned.

- ✓ Period of agreement: Minimum period and provision for renewal if any.
- ✓ Condit ions under which agreement ma y be altered, terminated and implications t hereof, such as settlement of amounts.
- ✓ Maintenance of Accounts:

Maintenance of accounts separately in the name of the client as are necessary of account for the assets any y additions, income, receipts and disbursements in connection there with, as provided under SEBI (Portfolio Managers) regulations, 1993.

- ✓ Terms of Fees:

The quantum and manner of payment of fees and charges for each for which the services are rendered by portfolio managers directly and indirectly such advisory, invest management, transfer, registration and transaction costs with specific references to brokerage costs, custody charges, co* elated to furnishings' relevant, communication, accountant statement, miscellaneous expenses (individual expense in excess of 5 percent to be indicated separately). Etc.

- ✓ Billing: Periodicity of billing, whether payment to be made in advance, manner of payment of fees, when sett ing off against the account, etc. type of documents evidencing receipt of payment of fees.
- ✓ Liability of Portfolio Manager: Liability of Portfolio Manager in connection with recommendations made, to cover errors of judgment, negligence, willful misfeasance in connection with discharge of duties, acts of other intermediaries, brokers, custodian, etc.
- ✓ Liability of client restricting the liability of the client to the extent of his investment.
- ✓ Death or disability: Providing for continuation/termination of the agreement in the event of client's death/ disability, succession, nomination, representation, etc. to be incorporated.
- ✓ Assignment conditions for assignment of the agreement by client.
- ✓ Governing Law: The law/ jurisdiction of country/ State which governs the agreement are to be stated.
- ✓ Settlement of grievances/disputes and provision for arbitration Provisions to cover protection of act done in good faith, risks and losses, rederessal of grievances, dispute resolution mechanism reference for arbitration and the situations under which such rights may arise, may be made.

Disclosures

The Portfolio Manager shall provide to the client the Disclosure Document as specified in Schedule V, along with a certificate in Form C as specified in Schedule I, at least two days prior to entering into an agreement with the client as referred to in sub - regulation (I). The disclosure document shall inter alia contain the following:

The quantum and manner of payment of fees payable by y the client for each activity for which service is rendered by the Portfolio Manager in Schedule I, at least two days prior to entering into an agreement with the client as referred to in sub- regulation (1). The Disclosure Document shall inter alia contain the following:

- ✓ Portfolio risks;
- ✓ Performance of portfolio manager
- ✓ The audited financial statements of the portfolio preceding three years

3. Define mutual funds and describe the various schemes that can be offered by it.

Mutual funds are associations or trusts of public members who wish to make investment in the financial instrument or assets of the business sector or corporate sector for the mutual benefit of its members.

Various schemes of mutual funds:

Operational classification:

Close ended funds:

Close ended funds are funds which have definite period or target amount. Once the period is over and or the target is reached, the door is closed for the investors. They cannot purchase any more units. These units are publicly traded through stock exchange and generally, there is no repurchase facility by the fund. The main objective of this fund is capital appreciation. Thus after the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unit holders in proportion to their holding. Thus the fund ceases to be a fund, after the final distribution.

E.g. UTI Master Share, 1986

Open ended funds:

Open ended funds are those which have no fixed maturity periods. Open ended scheme consists of mutual funds which sell the units to the public. These mutual funds can also repurchase the units.

Initial Public Offer (IPO) is open for a period of 30 days and then reopens as an open-ended scheme after a period not exceeding 30 days from the date of closure of the IPO. Investors can buy or repurchase units at net asset value or net value related prices, as decided by the mutual fund. Example: Unit Trust of India ‘s Growth sector funds.

Income fund:

Income funds are those which generate regular income to the members on a periodical basis. It concentrates more on the distribution of regular income and it also sees that the average return is higher than that of the income from bank deposits.

- ✓ The investor is assured of regular income at periodical intervals
- ✓ The main objective is to declare regular dividends and not capital appreciation.
- ✓ The investment pattern is towards high and fixed income yielding securities
- ✓ It is concerned with short run gains only.

Growth fund:

Growth are those which concentrate mainly on long term gains i.e., capital appreciation. Hence they are termed as “Nest Eggs” investments.

- ✓ It aims at meeting the investors’ need for capital appreciation.
- ✓ The investor ‘s strategy conforms to investing the funds on equities with high growth potential.
- ✓ The Investment tries to get capital appreciation by taking much risks and investing on risk bearing equities and high growth equity shares.
- ✓ The fund declares dividends.
- ✓ It is best suited to salaried and business people.

Balanced fund:

It is a balance between income and growth fund. This is called as Income cum growth. It aims at distributing regular income as well as capital appreciation. Thus the investments are made in high growth equity shares and also the fixed income earning securities.

Specialised funds:

These are special funds to meet specific needs of specific categories of people like pensioners, widows etc.

Money market mutual funds:

The funds are invested in money market instruments. These funds basically have all the features of open ended funds but they invest in highly liquid and safe securities like commercial paper, bankers' acceptances, and certificates of deposits treasury bills. These funds are called money funds in the U.S.A. The RBI has fixed the minimum amount of investment as Rs.1 Lakh; it is out of the reach of many small investors. However, the private sector funds have been permitted to deal in money market mutual funds. It is best suited to institutional investors like banks and other financial institutions.

Taxation funds:

It is a fund which offers tax rebated to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax rebates particularly during the month of February and March. An investor is entitled to get 20% rebated in Income Tax for investments made under this fund subject to a maximum investment of Rs.10, 000 per annum. E.g. Tax Saving Magnum of SBI Capital Market Limited.

Other Classification:

Leveraged Funds:

Also called as borrowed funds as they are used primarily to increase the size of the value of portfolio of mutual funds. When the value increases, the earning capacity of the fund also increases.

Dual Funds:

It is a fund which gives a single investment opportunity for two different types of investors. It sells income shares and capital. Those investors who seek current investment income can purchase incomes shares. The capital shares receive all the capital gains earned on those shares and they are not entitled to receive any dividend of any type.

Index Fund:

It is a fund based the some broad market index. This is done by holding securities in the same proportion as the index itself. The value of these index linked funds will automatically go up whenever the market index goes up and vice versa.

Bond Funds:

The funds have portfolios consisting mainly of fixed income securities like bonds. The main thrust is income rather than capital gains.

Aggressive Growth Funds:

These funds are capital gains oriented and thus the thrust area of these funds is capital gains. Hence, these funds are generally invested in speculative stocks They may also use specialized investment techniques like short term trading, option writing etc.,

Off shore Mutual Funds:

These funds are meant for nonresident investors. These funds facilitate flow of funds across different countries, with free and efficient movement of capital for investment and repatriation.

Property Fund:

These funds are real estate mutual funds. Its investment also includes shares/bonds of companies involved in real estate and mortgage backed companies.

Fund of Funds:

It is a fund that invests in other mutual fund schemes. The concept in prevalent in abroad.

FACTORS TO BE CONSIDER BEFORE SELECTING A MUTUAL FUND:

Here are a few factors to consider before selecting a mutual fund:

Risk appetite:

Those who start investing early in life benefit because their investments have more time to grow. So, the younger investors can take more risk compared to people close to their retirement years. People with more disposable incomes and lesser debt obligations can invest in growth-oriented funds. Balanced funds invest largely in equity and have exposure to debt instruments as well. Hence, for those with a moderate risk appetite, balanced funds yield decent returns.

Investment tenure:

It makes more sense to hold investments carrying higher risk for longer time periods. Investments held for more than five years have the potential to generate higher returns. In the event of an economic slowdown or a market crash, long-term investments have more time to recover.

Investment goals:

Some people want to save for children's education or augment funds for retirement planning. If these are goals set over the long term, equity funds may yield good returns. However, if you need funds for your child's marriage that might take place after two years, locking all your money in equity mutual funds may not be a good idea. This is because capital preservation is not guaranteed by funds.

Performance:

Compare the mutual fund's performance with that of other similar funds. While there is no guarantee that the fund can repeat the previous year's performance, it will give an idea of the fund and the manager's strategy. Verify if the performance is consistent over the last few years. Further, select a fund with lower expense ratio and other administrative charges.

4. Discuss the features of mutual fund investment.

Qualified and experienced professionals manage Mutual Funds. Generally, investors, by themselves, may have reasonable capability, but to assess a financial instrument, a professional analytical approach is required in addition to access to research and information, time and methodology to make sound investment decisions.

Since Mutual Funds make investments in a number of stocks, the resultant diversification reduces risk. They provide the small investors with an opportunity to invest in a larger basket of securities.

The investor is spared the time and effort of tracking investments, collecting income, etc. from various issuers, etc.

It is possible to invest in small amounts as and when the investor has surplus funds to invest.

Mutual Funds are well regulated & governed by SEBI (Mutual Funds) Regulations, 1996 thereby ensuring transparency of investments.

In case of open-ended funds, the investment is very liquid as it can be redeemed at any time with the fund, unlike direct investment in stocks/bonds.

Advantages of Mutual Fund

Professional Management

Mutual Funds provide the services of experienced and skilled professionals, backed by a dedicated investment research team that analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.

Diversification

Mutual Funds invest in a number of companies across a broad cross-section of industries and sectors. This diversification of investment ensures regular returns and capital appreciation at reduced risk.

Convenient Administration

Investing in a Mutual Fund reduces paperwork and helps you avoid many problems such as bad deliveries, delayed payments and follow up with brokers and companies. Mutual Funds save your time and make investing easy and convenient.

Return Potential

Over a medium to long-term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.

Low Costs

Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.

Liquidity

A peculiar advantage of a mutual fund is that investment made in its schemes can be converted into cash without heavy expenditure on brokerage, delays, etc. According to the regulation of SEBI, a mutual fund in India is required to ensure liquidity.

Transparency

Investors get regular information on the value of their investment in addition to disclosure on the specific investments made by their scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook.

Flexibility

Through features such as regular investment plans, regular withdrawal plans and dividend reinvestment plans, you can systematically invest or withdraw funds according to your needs and convenience.

Affordability

Investors individually may lack sufficient funds to invest in high-grade stocks. A mutual fund because of its large corpus allows even a small investor to take the benefit of its investment strategy.

Choice of Schemes

Mutual Funds offer a family of schemes to suit your varying needs over a lifetime.

Well Regulated

All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI.

Problems of mutual fund in India

- ✓ Lack of Innovation.
- ✓ Inadequate Research.
- ✓ Conventional pattern of investment.
- ✓ No provision for performance guarantee.
- ✓ Inadequate disclosures.
- ✓ Delays in service
- ✓ No rural sector investment base

5. How can you calculate mutual fund units (NAV)?

The mutual funds are bought and sold on the basis of units, and the investors are called the unit holders (as in the equity market, the investors are called shareholders).

The governing body of mutual funds is SEBI.

When you invest in a mutual fund, you are buying units or portions of the mutual fund and thus on investing becomes a shareholder or unit holder of the fund. The investors profit and loss are determined as per the units of mutual funds they hold as per the NAVs.

Unlike a stock price, NAV changes constantly according to the forces of supply and demand, NAV is determined by the daily closing value of the underlying securities in a fund's portfolio (total net assets) on a per share basis.

NAV = Net asset - Net liability / No. of shares currently issued and outstanding

Net asset= Market value of funds investment + receivable + accrued income

Sales Price = (Market Value of Assets – Liabilities) + (Brokerage Charges, Commission, Taxes, Stamp Duty, other Management and Administrative expenses) / Number of fund's units outstanding

Repurchase Price = (Market Value of Assets – Liabilities) - (Brokerage Charges, Commission, Taxes, Stamp Duty, other Management and Administrative expenses) / Number of fund's units outstanding

Rate of Return on Units = (NAVt-NAVt-1) +Dividends + Capital Gains / NAVt-1

Where:

NAV = Net Asset Value

t = Current Year

t-1 = Previous Year

SEBI has provided the 4 tier system for managing the MFs. The 4 constituents are-:

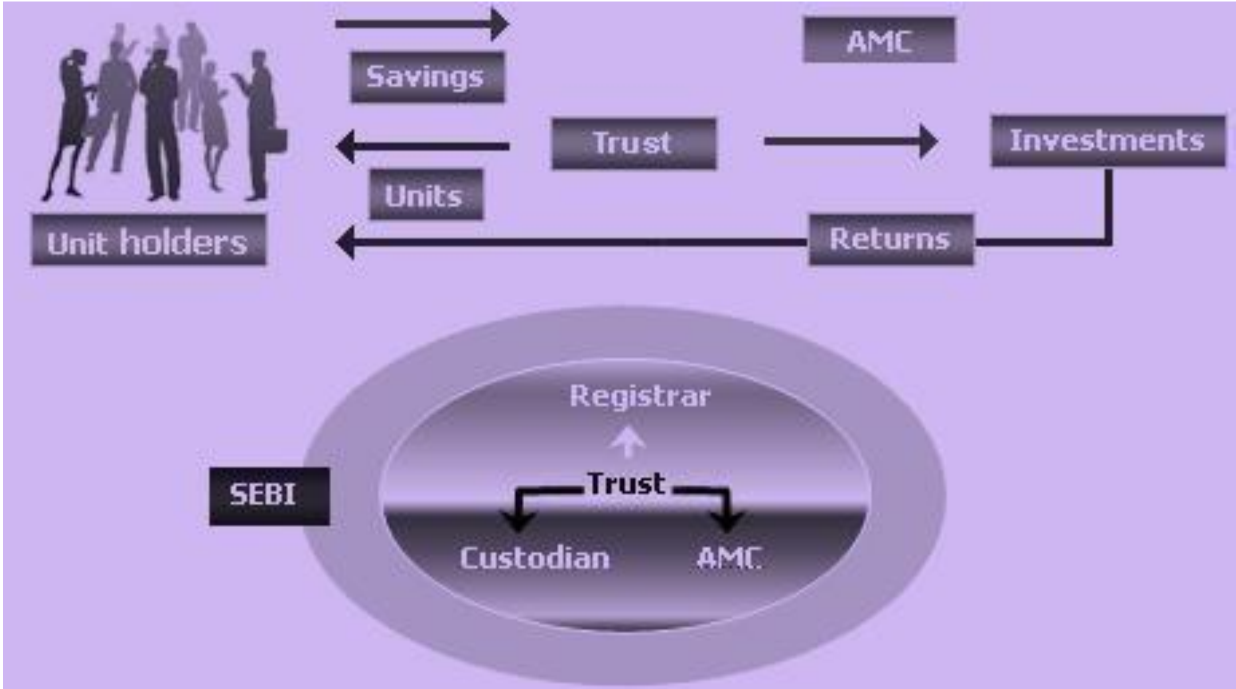
- ✓ Sponsor - The sponsor initiates the idea to set up a mutual fund. It could be a registered company, scheduled bank or financial institution. A sponsor has to satisfy certain conditions, such as on capital, track record (at least five years' operation in financial services), default-free dealings and a general reputation of fairness.
- ✓ Trust/board of trustees- The sponsor appoints the trustees. Trustees hold the responsibility towards unitholders by protecting their interests. Trustees check the market schemes, and secure necessary approvals. They check if the AMC's investments are within defined limits, whether the fund's assets are protected, and also ensure that unitholders get their due returns
- ✓ Custodian- It is an independent organization, which takes custody of securities and other assets of a mutual fund. In public sector mutual funds, the sponsor or trustee generally also acts as the custodian. Its responsibilities include receipt and delivery of securities, collecting income, distributing dividends, safekeeping of units and segregating assets and settlements between

schemes. Custodians can service more than one fund.

- ✓ Fund Managers/AMC-They are the ones who manage your money. An AMC takes investment decisions, compensates investors through dividends, maintains proper accounting and information for pricing of units, calculates the NAV, and provides information on listed schemes and secondary market unit transactions. It also submits quarterly reports to the trustees. A fund's AMC can neither act for any other fund nor undertake any business other than asset management.

Except the above following authorities are also related with the management of MFs.

- ✓ Principal Underwriter-Sells fund shares, either directly to the public or through other firms (such as broker dealers).
- ✓ Transfer Agent- Executes shareholder transactions, maintains records of transactions and other shareholders' account activities, and sends account statements and other documents to shareholders.
- ✓ Independent Public Accountant- Certifies the fund's financial statements



SHORTCOMINGS OF MUTUAL FUNDS

Mutual funds have their drawbacks and may not be for everyone:

- ✓ No Guarantees
- ✓ Fees and commissions
- ✓ Taxes
- ✓ Externally managed
- ✓ No Minimum return
- ✓ More number of schemes (confused)

6. What Is a Derivative? Explain various derivatives in detail.

Derivatives are contracts that gain their value from the value of financial variables. Financial variables used to trade derivatives are also known as underlying. They include commodity prices, interest rates, oil prices, prices of metals, equity indices, real estate indices, Cryptocurrencies, temperature changes, etc.

Derivatives can either be linear or non-linear.

Linear vs. Nonlinear Derivatives

A linear derivative is one whose value is directly related to the market price of the underlying variable. What does that mean?

If the underlying makes a move, the value of the derivative moves with a nearly identical margin. In fact, there is a 1:1 relationship between the derivative and the underlying – explaining why linear derivatives are said to be "delta-one" products. However, the delta itself need not always be equal to 1. Examples of linear derivatives include futures and forwards.

A non-linear derivative is one whose value/payoff changes with time and space.

Space, in this case, refers to the location of the strike/exercise price with respect to the spot/current price. The payoff varies with the underlying value but also exhibits some non-linear relationship with other variables, including interest rates, dividends, or even volatility. Non-linear derivatives are generally referred to as options.

For non-linear derivatives, the delta is not constant. Rather, it keeps on changing with the change in the underlying asset. Examples include the Vanilla European option, Vanilla American option, Bermudan option, etc.

Uses of Derivatives

Derivatives are majorly used to hedge or to speculate. The following are specific examples of the uses of derivatives.

Companies use derivatives to manage various risks: interest rate risk, foreign exchange risk, and commodity price changes to risk.

Some mortgages have derivatives embedded in them to give the mortgagee the option of paying early, for example, when the interest rates are lower.

Employees are sometimes given the option of buying shares from the company at a future date at a predetermined price to compensate them.

Options have been embedded in capital Investment opportunities to give room for expanding or doing away with the project depending on the turn of events.

Some corporate bonds may have derivatives embedded in them. These derivatives will give the bond issuers and holders the right to repay them or redeem them early/ convert them to shares respectively.

Over-the-Counter Trading vs. Exchange Trading

Over-the-Counter Markets

In the over-the-counter market, trading occurs between participants who contact each other directly or through a broker. Participants may be able to trade privately without the other party being aware of the terms, including the price. Stocks traded in an OTC market could belong to a small company that's yet to satisfy the conditions for listing on the exchange. The OTC market is also popular for large trades. Since the 2007-2009 financial crisis, OTC markets are, however, increasingly being regulated. Some of the regulations include:

- ✓ Standardized OTC derivatives must be traded on platforms called swap execution facilities.
- ✓ The central registry must have all the records of any trade.
- ✓ Dealers trading with other dealers should use a central counterparty
- ✓ Exchange-Traded Markets
- ✓ Investors trade in contracts that have been identified in the exchange. Traditionally trading was done using the outcry system (Investors met at the exchange floor and used signals to indicate their proposed trades.) Currently, trading is done electronically through a computer.

Advantages of OTC Markets over Exchanges

- ✓ There are fewer restrictions and regulations on trades.
- ✓ The participants have the freedom to negotiate deals.
- ✓ It's cost-effective for corporates as service costs lower.
- ✓ There's better information flow between a market maker and the customer, thanks to one-on-one contact.

Disadvantages of OTC Markets Compared to Exchanges

- ✓ There's increased credit risk associated with each OTC trade.
- ✓ Less transparency.

Market Size

The years 1997-2017 saw the exchange-traded market and the OTC markets growing by a factor of 6 and 7.4, respectively.

Options, Futures, and Forwards

Options

An option contract is an agreement between two parties to transact on underlying security at a predetermined price called the strike price before some date called the expiration date. The option gives the holder a right but not the obligation to buy/sell the underlying at an agreed-upon date at the strike price.

Options not only hedge against risk but also provide additional protection against adverse price movements. In other words, they protect against negative risk while preserving upward payoffs.

All European options can only be exercised at maturity. On the other hand, American options may be exercised any time between the issue date and expiration. As such, the price of an option is directly proportional to its maturity date. For example, the premium paid for an out-of-the-money option on Apple expiring in one month will be less than the premium paid for an option with the same strike price expiring in one year.

A call option gives the holder the right but not the obligation to buy the underlying asset at the strike price before the expiration date. On the other hand, a put option gives the holder the right but not the obligation to sell the underlying asset at the strike price before the expiration date.

Forwards Contracts

A forward contract is a non-standardized contract – traded in an over-the-counter market –between two parties that specifies the price and the quantity of an asset to be delivered in the future. That it's non-standardized implies it cannot be traded on an exchange. Instead, they are traded in the OTC market. One party takes a long position and agrees to buy the underlying asset at a specified price on the specified date, while the other party takes a short position and agrees to sell the asset on that same date at that same price.

The agreed-upon price is called the forward price. The price at which the dealer wants to buy is called the bid price, while the price the dealer wants to sell is called the ask price.

The bid price is the "quoted bid," or the highest price, which a dealer is willing to pay to purchase a security. The offer price is the price at which the security is offered for sale, also known as the "asking price." The bid-ask spread represents the difference between the offer price and the bid price.

Forward Contract Payoff

Consider a forward contract on a Stock. Let S_T be the stock price at the maturity of and K be the delivery (forward price at the initiation of forward contract). The payoff of the long and short positions is given below.

The payoff to the long position (the buyer of the forward contract) is given by:

$$\text{Payoff} = S_T - K$$

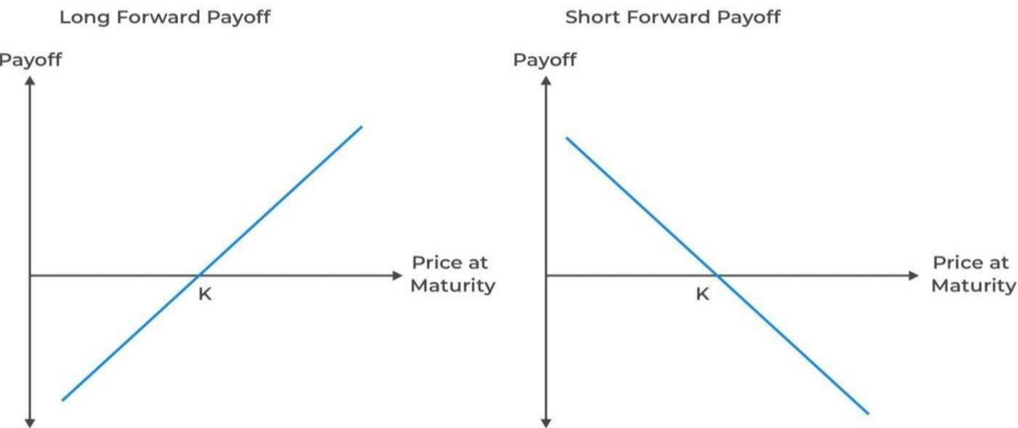
Where:

S_T = spot stock price at maturity of the forward contract.

K = delivery price.

The payoff to the short position (seller of the) = $K - S_T$

Consider the following diagram:



The graphs above imply that for a trader in a long position, the payoff () will be beneficial when the underlying price (which is the stock price in our case) is high. On the other hand, for a trader in a short position, the payoff will be beneficial with a lower underlying price.

Example: Calculating the Payoff of a Forward Contract

Consider the forward contract on CAD- EUR exchange rate. The spot bid and ask prices per one euro are CAD 1.1080 and CAD 1.1083, respectively. The 6-month bid and ask prices are CAD 1.1120 and CAD 1.1125, respectively.

Suppose that company X enters into a long position to buy 10 million euros in six months. If the actual CAD- EUR exchange rate in six months is CAD 1.1200 per euro, calculate the profit to company X.

Solution

Based on the 6-month bid-ask exchange rates, company X buys 10 million euros for CAD 1.1125 (that is K = 1.1125). Consequently, the profit made by company X is

$$10{,}000{,}000\times(1.120-1.1125)=\text{USD}75{,}000$$

Note: The short position of the above made a transaction made a loss of:

$$10{,}000{,}000\times(1.1125-1.1200)=-\text{USD}75{,}000$$

Futures

A futures contract is a standardized, legally binding agreement – traded in on an exchange – between two parties that specifies the price to trade a given asset (commodity or financial instrument) at a specified future date.

Note that future contract offers similar payoffs as forward contracts. However, futures contracts trade on exchanges; that is, the underlying asset and possible maturity date are clearly stated in the contract.

Futures contracts differ from forwards in several other aspects:

- ✓ Clearing house: The clearinghouse is an interposed party between the buyer and the seller, which ensures the performance of the contract. In essence, futures contracts have no credit risk.
- ✓ Marking to market: Since the clearinghouse must monitor the credit risk between the buyer and the seller, it performs daily marking to market. This is the settlement of the gains and losses on the contract on a daily basis. It avoids the accumulation of large losses over time, leading to default by one of the parties.
- ✓ Margins: Daily settlements may not provide a buffer strong enough to avoid future losses. For this reason, each party is required to post collateral that can be seized in the event of default. The initial margin must be posted when initiating the contract. If the equity in the account falls below the maintenance margin, the relevant party must provide additional funds to cover the initial margin.

Options

Options are derivatives that offer the investor the right (but not the obligation) to buy or sell an asset in the future at a fixed price. Options can be found on exchanges and in the over-the-counter market. There are two types of options: call and put options.

In a call option, the holder has the right but not the obligation to buy the underlying asset (for example, stock) at a specified time within a specified period. In a put option, the holder has the right but not the obligation to sell the underlying asset at a specified price within a specified period.

An option contract involves two parties: the party with a long position and a short position in the option.

In the case of a call option, the party in a long position has the right but not the obligation to purchase an asset from a short position at a specified price called the strike price or exercise price within a given period.

For the put options, the party in a long position has the right but not the obligation to sell an asset from a short position at a specified price called the strike price or exercise price within a given period.

Option Payoffs

Call Option Payoff

Consider a European call option on a stock that will be exercised at time T. Let K be the strike price, and S_T be the stock price at time T. Consider the buyer of the call option (long position in the call option). By definition, the buyer will exercise the option if $S_T>K$ and thus the payoff of the buyer is S_T-K. Intuitively, if $S_T<K$ the option is not exercised, and thus the payoff to the buyer is 0.

The payoff to the buyer and seller is summarized below:

To the buyer (long position in the call option),

$$CT=\max(0,ST-K)$$

Where:

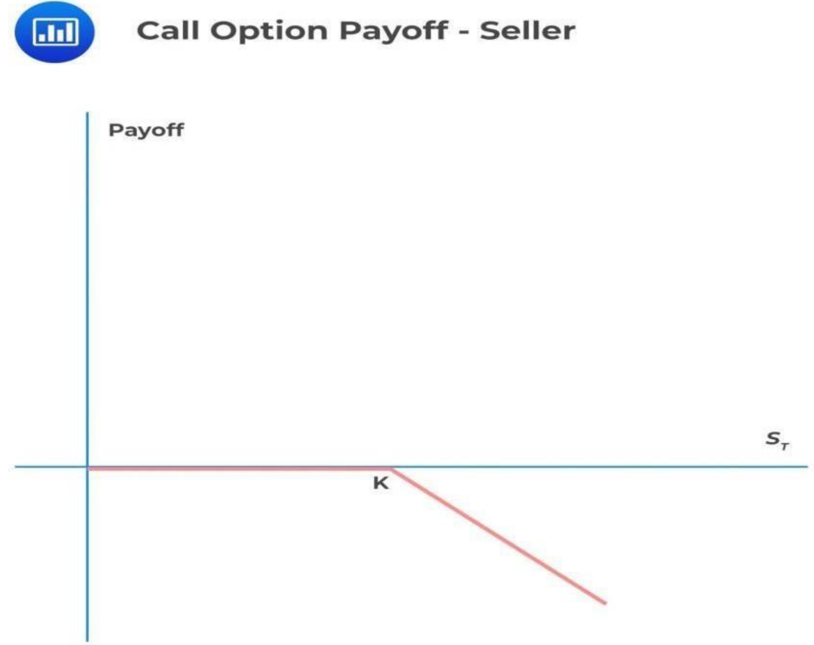
CT = call option payoff at time T.

S_T = stock price at maturity.

K = strike price

The graph of the payoff of a long position in the call option is shown below:

To the seller, payoff = $-C_T$. The payoff of the short position in the call option is shown below:



The price paid for the call, C_0 is also called the call premium.

Thus,

Profit to the call option buyer $=C_T-C_0$

Profit to the call option seller $=C_0-C_T$

Put Option Payoff

Using the same variables as a call option, and by definition of a put option, the European put option is exercised if $S_T < K$. In other words, the buyer of the option has the right to sell the stock for KK. Therefore, if exercised, the payoff to the buyer (long position in the put option) is $K- S_T$. Intuitively, the put option is not exercised if $S_T > K$ and thus, the option is worthless to the buyer.

The payoff to the buyer and seller is summarized below:

To the buyer (long position in the put option),

$P_T=\max(0, X-S_T)$ $P_T=\max(0, X-S_T)$

Where:

P_T =put option payoff.

S_T=stock price at maturity.

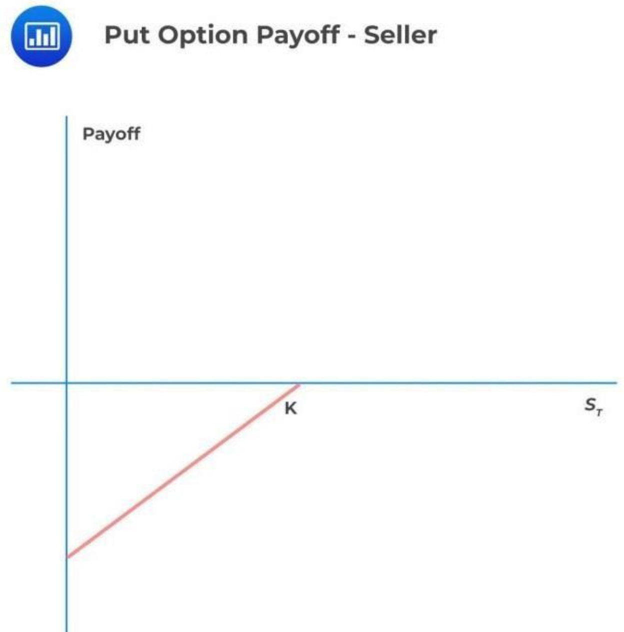
X=strike price.

The payoff of a long put is shown in the following graph:

To the seller (short position in the put option),

payoff =$-P_T - P_T$.

The graph of the short put is shown below:



The price paid for the put, P_0 is also called the put premium.

Thus,

Profit to put option buyer = $P_T - P_0$

Profit to the put option seller =$P_0 - P_T$

Risks in Derivative Trading

Market Risk

There are no guarantees the market price will move in favor of the derivative trader. For example, an investor who is short in a put option has no guarantees that the underlying price will stay above the strike price, allowing them to keep the premium. The underlying's price could as well fall below the strike, in which case the option buyer exercises the option, forcing the seller to buy a stock at a price that's higher than its market price.

Counterparty Risk

There's always the risk that the buyer, seller, or dealer will default on the contract. This risk is particularly prevalent in OTC markets where regulations are not as strict as in exchange.

Liquidity Risk

Closing out a deal prior to maturity, e.g., in an American option that can be exercised before maturity, can at times be difficult. Even more likely, bid-ask spreads could be so large as to represent a substantial cost.

Operational Risk

There's always the risk that a trader with instructions to use derivatives as a hedging tool will be tempted to take speculative positions, possibly in the hope of making a "kill'. Such a move can be disastrous for the firm.

7. Discuss the term VCs and PEs in financial market?

Venture capital and private equity are two types of financial assistance that are used by companies in different stages. They are often considered as one because of their similar concept. However, there is a significant difference between these two concepts. Private Equity is a large investment in developed companies and venture capital is a small investment usually made in initial stages of development of a company.

Private equity funds refer to investments made by investors for investment purposes. Whereas, venture capital refers to funding to those ventures that are backed by new entrepreneurs, have high risks, and who require money to shape their ideas

What is Venture Capital?

Venture capital is referred to funds invested by individuals or investors to start-ups or small companies aspiring to establish a fresh concept and new entrepreneur. All those new private companies who cannot raise their funds from the public sector may raise funds from the venture capital.

This type of investment indicates high risk but is supported by fresh and top qualified entrepreneurs. Venture Capital firms assist developing businesses in their initial stages before making it public.

It is a popular funding process and sometimes required to raise money for bank loans, capital markets, or other debt instruments. These type of investor is known as a Venture Capitalist, and the capital they provide is called equity capital.

What is Private Equity?

Private equity can be defined as the capital investment, which is made by companies or investors in the private firms that are not a part of the stock exchange. These fund investments are made by the

high net worth firms or individuals. These investors acquire private companies shares or earn authority of public companies to take them private and de-list from public stock exchanges.

Private Equity firms purchase an existing company and help them to develop and expand. The primary strategy of this entity is Venture Capital, Mezzanine Capital, Leveraged Buyout, and Growth Buyout.

This entity has become an essential part of the financial services and is one of the attractive funding options.

8. Explain the various types of venture capital.

Introduction:

The venture capital investment helps for the growth of innovative entrepreneurships in India. Venture capital has developed as a result of the need to provide non-conventional, risky finance to new ventures based on innovative entrepreneurship.

Venture Capital:

It is a long term capital invested in companies which involves high risk. The financing involves high risk but is compensated by high return.

Types of Venture Capital in India

The venture capital institutions (VCIs) in India can be broadly classified into 5 types.

I. Venture Capital companies promoted by Development Banks
II. State level Venture capital companies
III. Commercial banks promoted Venture capital companies
IV. Private sector Venture capital companies
V. Foreign venture Capital funds.

I. VC companies promoted by Development banks

IDBI – VFC (Venture Fund Company) : IDBI promoted venture fund company in the year1986. It is promoted by the Technology Development Wing of IDBI.

TDICI - Technology Development and Information company of India Ltd. This wasstarted in January 1988 with the support of ICICI and UTI. This is the country’s first venture fund (Venture Capital Unit

Scheme). It was started with an initial fund of Rs.20 Crores and it has financed nearly 37 small and medium scale enterprises. At present, it has a total fund of Rs.120 crores. The initial fund has yielded a return of Rs.16 crores.

RCTC – Risk Capital and Technology Finance Corporation Ltd: It is a subsidiary of IFCI, started in January 1988. Its resource base has Rs.30 crores which has contributions from UTI, IFCI and World Bank.

II. State level Venture Capital companies:

There are two state-level venture fund companies in India. They are 1. Gujarat Venture Finance Ltd. 2. Andhra Pradesh Venture Capital Limited (AVCL).

Gujarat Venture Finance Ltd: Gujarat Industries Investment Corporation Ltd., along with Gujarat Lease Finance Corporation Ltd., Gujarat Alkalies & Chemicals Ltd., and Gujarat State Fertilizer Ltd., promoted Gujarat Venture Finance Ltd. It has a venture fund of Rs.24 crores andwas started in 1990.

Andhra Pradesh Venture Capital Limited (AVCL): This was promoted by APIDC (Andhra Pradesh Industrial Development Corporation), IDBI, Andhra Bank and Indian Overseas Bank.

III. Venture Capital Companies promoted by Commercial Banks:

Notable among the venture companies promoted by the commercial banks, Canara Bank venture Capital Fund (CVCF), Grind lays Bank has promoted India Investment Fund and Second India InvestmentFund. SBI Capital Venture Capital Fund.

IV. Private sector Venture Capital companies in private sector, we have Larazd Credit Capital Venture Fund and Indus Venture Management Ltd. (IVML).

V. Foreign Venture Capital funds The Hong Kong Bank has promoted venture fund. Alliance Capital of U.S.A. has also promoted venture capital fund.

Importance of Venture capital in development of our country:

- ✓ Promotes Entrepreneurs: Just as a scientist brings out his laboratory findings to reality andmakes it commercially successful, similarly, an entrepreneur converts his technical know-how to a commercially viable project with the assistance of venture capital institutions.
- ✓ Promotes products: New products with modern technology become commercially feasible mainly due to the financial assistance of venture capital institutions.
- ✓ Encourages customers: The financial institutions provide venture capital to their customers not as a mere financial assistance but more as a package deal which includes assistance in

management, marketing, technical and others.

- ✓ Brings out latent talent: While funding entrepreneurs, the venture capital institutions give more thrust to potential talent of the borrower which helps in the growth of the borrowing concern.
- ✓ Promotes exports: The Venture capital institution encourages export oriented units because of which there is more foreign exchange earnings of the country.
- ✓ As Catalyst: A venture capital institution acts as more as a catalyst in improving the financial and managerial talents of the borrowing concern. The borrowing concerns will be more keen to become self-dependent and will take necessary measures to repay the loan.
- ✓ Creates more employment opportunities: By promoting entrepreneurship, venture capital institutions are encouraging self-employment and this will motivate more educatedunemployed to take up new ventures which have not been attempted so far.
- ✓ Brings financial viability: Through their assistance, the venture capital institutions not only improve the borrowing concern but create a situation whereby they can raise their own capital through the capital market. In the process they strengthen the capital market also.
- ✓ Helps technological growth: Modern technology will be put to use in the country when financial institutions encourage business ventures with new technology.
- ✓ Helps sick companies: Many sick companies are able to turn around after getting proper nursing from the venture capital institutions.
- ✓ Helps development of Backward areas: By promoting industries in backward areas, venture capital institutions are responsible for the development of the backward regions and human resources.
- ✓ Helps growth of economy: By promoting new entrepreneurs and by reviving sick units, a fillip is given to the economic growth. There will be increase in the production of consumer goods which improves the standard of living of the people

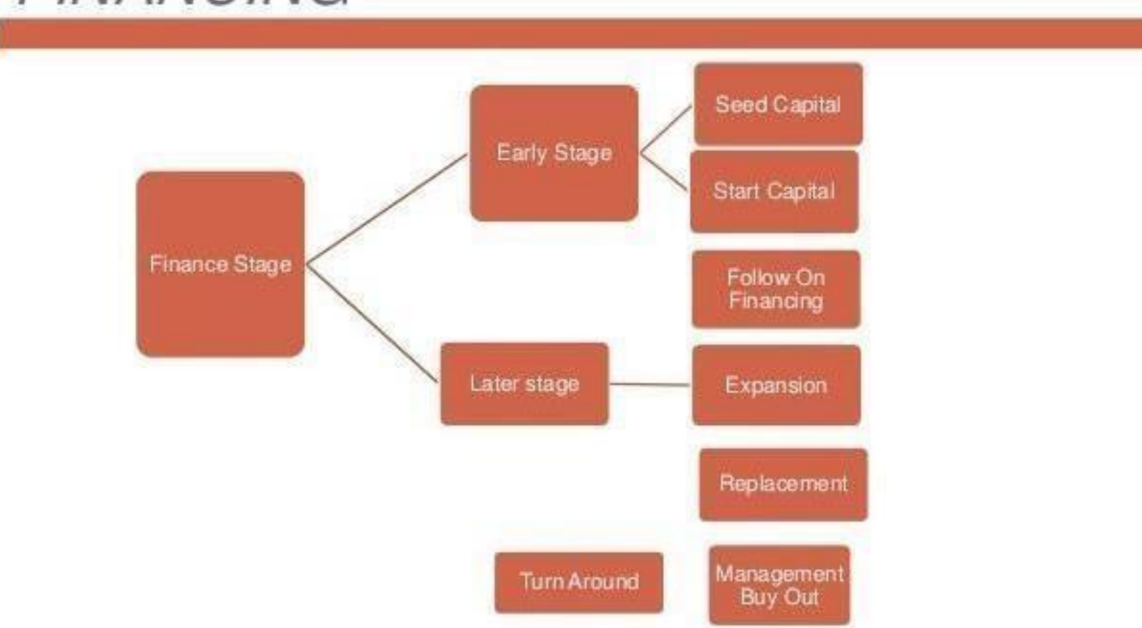
9. Explain Venture Capital Investment Process.

Explain the stages of venture capital / Enumerate the mechanics of venture capital. Why it is called as “seed capital”?

Venture Capital Financing Process

There are several ways to attract funding. However, in general, the venture capitalfinancing process can be distinguished into five stages;

1) The Seed capital stage
2) The Start-up capital stage
3) Follow on financing
4) Expansion Financing
5) Replacement Financing
6) Management Buy out
7) Turnaround Financing



The Stages in Venture Capital (VC) Investing:

Early stage Financing:

1) Seed capital stage -

It is the capital provided for testing the product and examining the commercial viability of the

product. It enables the venture capital institution to find out the technical skill of the borrowing concern and its market potentially. So, we can say seed capital is more of a product development and all the finance required at this stage is provided by the venture capital institution.

2) Startup capital stage:

Startup of the product refers to the tested in the market and after being satisfied with its acceptability by the market, financing will be provided for further development of the product and marketing of the product.

The startup may be classified into four categories:

- ✓ A new high technology, introduced by the entrepreneur.
- ✓ A new business started by an entrepreneur who has a thorough working knowledge and experience – normally started by persons who were working in an established firm and having gained sufficient experience.
- ✓ New projects started by existing companies. EG: Retail business started by Hindustan Lever Limited.
- ✓ A new company promoted by existing company. Here, the venture capital institutionis keen to have a first-rated management which may have a second rated product. But not vice versa i.e., venture capital will not be provided for a concern having a second- rated management but a first-quality product.

3) Follow – on financing:

Follow on financing is otherwise called as second round of finance. After the initialstage after being commercially successful for want of some more finance.

After the product has been launched in the market, further funds are needed because thebusiness has not yet become profitable and hence new investors are difficult to attract. Venture capital funds provide finance at such stage, which is comparatively less risky than the first two stages. At this stage, finance is provided in the form of debt also, on which they earn a regular income

Later Stage Financing:

4) Expansion Stage financing:

Expansion finance may be needed by an enterprise for adding production capacity once it has successfully gained market share and expects growth in demand for its product. Expansion of an enterprise may take the form of an organic growth or by way of acquisition or takeover. In the case of organic growth, the entrepreneur retains maximum equity holdings of the entrepreneur and the

venture capitalist could be in much higher proportion depending upon factors such as the net worth of the acquired business, its purchase price and the amount already raised by the company from the venture capitalists.

5) Replacement Financing:

This stage is otherwise called as money out deal. In this form of financing, the venture capitalist purchases the shares from the existing shareholders of the company who are willingto exit from the company. Such a course is often adopted with the investors who want to exit from the investee company, and the promoters do not intend to list its shares in the secondary market, the venture capitalist perceives growth of the company over 3 to 5 years and expects toearn capital gain at a much shorter duration.

6) Management Buy-outs (MBO):

It is the capital used for acquiring all the shares and the voting rights to remove externalcontrol. EG: An Indian company's shares may be purchased by NRIs at the initial stage and after sometime these shares are bought back by the company with the help of profits and finance by venture capital institutions.

Management buy-in (MBI)

Management buy in is the case where the funds are provided for an outside group tobuy an ongoing company.

7) Turn Around: Turn around may be

Financial Turnaround: When the company is able to improve its conditions financially, it is called financialturnaround, which is due to the financial assistance by venture capital institution.

Management Turn around: similarly, when the management of the company makes a turnaround by becoming self -dependent and is able to face the challenges of business, itis calledmanagement turn around.

Exist Mechanism of Venture capital:

Initial Public Offering:

When the shares of the investee company are listed on the stock exchange(s) and arequoted at a premium, the venture capitalist offers his holdings for public sale through publicissue.

Buy back of Shares by the Promoters:

In terms of the agreement entered into with the investee company, promoters of the company are given the first opportunity to buy back the shares held by the venture capitalist, atthe prevailing market price. In case they refuse to do so, other alternatives are resorted to by the venture capitalist.

Sale of Enterprise to another Company:

Venture capitalist can recover his investments in the investee company by selling theholdings to outsider who is interested in buying the entire enterprise from the entrepreneur.

Sale to New Venture Capitalist:

A venture capitalist can sell his equity holdings in the enterprise to a new venture capital company, who might be interested in buying the ownership portion of the venture capital. Such sale may be distress sale by the venture capitalist to realise the investments and exit from the enterprise. Alternatively, such sale may be for inducting a willing venture capitalist who wishes to take the existing liability in the company to provide second round offunding.

Self-liquidating Process:

In case of debt financing by the venture capitalist, the process is self-liquidating in nature, as the principal amount, along with interest is realised in instalments over a specifiedperiod of time.

Liquidation of the Investee Company:

If the investee company does not become profitable and successful and incurs losses, the venture capitalist resorts to recover his investment by negotiation or settlement with the entrepreneur. Failing which the recovery is resorted to by means of winding up of the enterprise through the court.

10. Explain the Methods of Venture Financing:

Equity Instruments:

Equity instruments are ownership instruments and bestow the rights of the owner on the investor/VCFs. They are:

- ✓ Ordinary Shares on which no dividend is assured. Non-voting equity shares may alsobe issued, which carry a little higher dividend, but no voting rights are enjoyed by the investors. There may be different variants of equity shares also, e.g. deferred equity shares on which the ordinary shares rights are deferred till a certain period or happening of an event. Moreover, preferred

ordinary shares carry an additional fixed income.

- ✓ Preference Shares carry an assured dividend at a specified rate. Preference shares may be cumulative/non-cumulative, participating preference shares which provide for an additional dividend, after payment of dividend to equity shareholders. Convertible preferenceshares are exchangeable with the equity shares after a specified period of time. Thus, the venture capital fund can select the instrument with flexibility.

Debt Instruments: VCFs prefer debt instruments to ensure a return in the earlier years offinancing when the equity shares do not give any return. The debt instruments are of varioustypes, as explained below:

- ✓ Conditional Loans: On conditional loans, no interest rate as lower rate of interest and no payment period is prescribed. The VC funds, recover their funds, along with the return thereon by way of a share in the sales of the undertaking for a specified period of time. This percentageis pre-determined by VCFs. The recovery by the VCFs depends upon the success of the business enterprise. Hence, such loans are termed as 'conditional loans'.
- ✓ Convertible Loans: Sometimes loans are provided with the stipulation that they may be converted into equity at a later stage at the option of the lender or as agreed upon between the two parties.
  - ✓ Conventional Loans: These loans are the usual term loans carrying a specified rate of interest and are repayable in installments over a number of years.

11. Explain the features, objectives of Venture capital and explain financing about venture capital institutions.

Features of Venture Capital

- ✓ It is the financing of capital for new companies.
- ✓ This finance can also be loan-based or in convertible debentures
- ✓ Providers of venture capital aim at capital gain due to the success achieved by the borrowing concern.

- ✓ Venture capital is always a long-term investment and made in companies which have high growth potential.
- ✓ The venture capital provider take part in the business of borrowing concern simultaneously provides managerial skill.
- ✓ Venture capital financing contains risks. But the risk is compensated with a higher return.
- ✓ It involves financing mainly small and medium size firms, which are in their early stages. When the assistance of venture capital, these firms will stabilize and later can go in fortraditional finance.

Objectives of Venture Capital

- ✓ To finance new companies who find it difficult to go to capital market
- ✓ To provide long term finance to small and medium scale industries
- ✓ To provide managerial assistance
- ✓ To bring in rapid growth in the business

Financing by Venture Capital Institutions:

Before going in for venture capital finance, the venture capital institution will have toassess the potentiality of the borrowing concern by a proper appraisal. This appraisal will be similar to the project appraisal undertaken by commercial banks. There are three stagesinvolved in the venture capital finance.

Basic stage involves the study and evaluation of the project.

Operating stage deals with monitoring the functioning of the management of the borrowing concerns and advice for providing new round of finance. In the course of studying the managerial skill, the following aspects will be taken a) product quality b) Market size c) rate of return d) venture location e) growth potential f) state of entrepreneur

Exit stage – The borrowing company may be sold to a third party or the company may beleft to look after itself. While studying the managerial skill, he following aspects will be taken: a) Product quality b) Market size c) Rate of return d) Venture location e) Growth potential f) State of entrepreneur.

12. Explain the Guidelines provided for venture capital and explain SEBI venture capital fund Regulation.

Guidelines for Providing Venture Capital:

The venture capital companies have been given certain guidelines for providing venture capital. Accordingly, the venture capital companies must obtain a detailed report from the borrowing company. The report should contain the following details: -

- ✓ History of the borrowing company
- ✓ Available facility for the borrowing company
- ✓ Description of the products manufactured by the company
- ✓ Market trend of the products
- ✓ Cash flow position of the concern
- ✓ Operating profit
- ✓ Key personnel.

It takes about 6 months for a venture capital company to process the application during which period, aspects such as the organizational structure, competition for the company'sproduct, etc., are studied

SEBI Venture Capital Funds (VCFs) Regulations, 1996

A Venture Capital Fund means a fund established in the form of a trust/company; includinga body corporate, and registered with SEBI which (i) has a dedicated pool of capital raised in a manner specified in the regulations and (ii) invests in venture capital undertakings (VCUs) in accordance with these regulations.

A Venture Capital Undertaking means a domestic company (i) whose shares are not listed on a recognized stock exchange in India and (ii) which is engaged in the business of providing services/production/manufacture of articles/things but does not include such activities/sectors as are specified in the negative list by SEBI with government approval-namely, real estate, non-banking financial companies (NBFCs), gold financing, activities not permitted under the industrial policy of the Government and any other activity which may be specified by SEBI in consultation with the Government from time to time.

Registration

All VCFs must be registered with SEBI and pay Rs.25,000 as application fee and Rs. 5, 00,000as

registration fee for grant of certificate.

Recommendations of SEBI (Chandrasekhar) Committee, 2000 SEBI appointed the Chandrasekhar Committee to identify the impediments in the growth of venture capital industry in the country and suggest suitable measures for its rapid growth. Its report was submitted in January, 2000. The recommendations pertain to

- ✓ Harmonization of multiplicity of regulations
- ✓ VCF structures
- ✓ Resource raising
- ✓ Investments
- ✓ Exit
- ✓ SEBI regulations
- ✓ Company law related issues and
- ✓ Other related issues.

13. What is private equity? Explain its advantages and disadvantages.

What Is Private Equity (PE)?

Equities are referred to as private equity funds when investors invest directly in private companies. These equities are not listed on the exchanges and are regulated by industry-specific criteria. Generally, private equity investments have holding periods of a long time. Hence the investors attracted to private equities are generally retail investors or institutional investors who can afford to invest large sums of corpus for a longer period. This huge capital is later used by the company to fund expansions, buy new technologies, strengthen the company's balance sheet, etc. These funds have investing term of 10 to 13 years and after the expiry, the fund is closed, and the fund is returned to the partners.

Types of Private Equity (PE) Firms

Investors investing in private equity firms have a different range of investment preferences. Many investors are passive investors who typically depend on the management of the company for the returns that are generated from the revenue. On the other hand, some of the investors are referred to as active investors. This type of investor offers operational support to the management to grow.

The active private equity firm maintains relationships with the C-level management like CEOs and CFOs for the growth of the company. They know the company's operations and are well aware of

the synergies. When investors are involved at the operational level to improve the company's growth they are usually viewed favorably by sellers.

How Private Equity (PE) Creates Value?

Private equity performs two critical functions to create value –

- ✓ Deal origination/Transaction execution
- ✓ Portfolio oversight

The first function of deal origination involves creating, maintaining, and developing relationships with mergers and acquisitions (M&A) intermediaries, investment banks, and similar transaction professionals to safeguard both high-quantity and high-quality deal flow. Transaction execution involves assessing management, the industry, historical financials, and forecasts, and conducting value evaluation.

Some firms appoint internal staff to proactively identify and reach out to company owners to generate transaction leads. When internal staff is hired it reduces the unnecessary costs involved in investment banking middleman's fees.

When both parties decide to make the deal, then the deal professionals along with various transaction advisors, including investment bankers, accountants, lawyers, and consultants, execute the due diligence phase.

Introduction to Private Equity (PE) in India

In India, in the last 13 years, almost $100 billion of capital is injected into the private equity market. Many companies have benefited from this vital funding source. This capital from private equity has helped many small and medium-sized enterprises to grow. This has generated employment opportunities and influenced the development of strategic capabilities.

In 2017 itself, there was an inflow of private equity capital of around $26.5 billion and the momentum is expected to continue in the coming years as well.

What are Private Equity (PE) Funds?

Private Equity Funds invest in unlisted private companies in exchange for a share of their ownership. Unlisted companies usually go for PE funds when they are unable to fund themselves through the issuance of equity or debt instrument, or venture capitalists.

These companies offer investors a diversified portfolio which lowers the risk factor. The investment term of a PE Fund ranges from 4 to 7 years. After 7 years, the firm expects the investors to exit the investment and earn good returns.

Advantages of Investing in Private Equity (PE) Funds

Following are some of the advantages of investing in private equity funds –

- ✓ Untapped Potential

Company investments for private equity have a lot of untapped potentials. Investors can generate decent returns by investing in unlisted privately-owned companies which has great growth potential. Investors can also find opportunities of investing in companies that aren't doing well on the stock market and later become private.

- ✓ Stringent Company Selection Process

Firms that manage private equity investments are very particular about investing in potential companies and use a significant amount of resources to assess such companies. They also take care of the risk factor involved and make efforts to minimize the same. After filtering all the potential companies, they go for companies that present investors with all the crucial characteristics.

- ✓ Clear Accountability

Management teams of private equity-owned companies are liable to an engaged professional shareholder who has the right to safeguard their shareholding and act accordingly.

Private Equity (PE) Investment Strategies

- ✓ Venture Capital

The pool of capital when invested in companies that are not completely formed and lack access to traditional financing means or financial markets.

- ✓ Growth Capital

The growth capital is used to fund already set private company which fall short on required assets. Due to a lack of the required assets, such companies cannot use the conventional means of financing required for further expansion.

- ✓ Leveraged or Management Buyouts

When the capital is used as additional leverage to push the existing management of the company towards the target.

- ✓ Turnaround / Distress Situations

When the company is unable to recover the existing debt it opts for equity capital funding. The funds are used to stabilize the company’s balance sheet, along with the support of turnaround strategies led by the management.

Private equity firms attract many wealthy investors and institutions. This financial instrument best and brightest from the corporate who invest in PE funds to increase the value of their portfolio companies. For better understanding of PE funds individual investors must know how the value is created in Private Equity Market.