Analysis of financial markets in India

Akash Bharadwaj(ugc net,gold medalist)

ABSTRACT

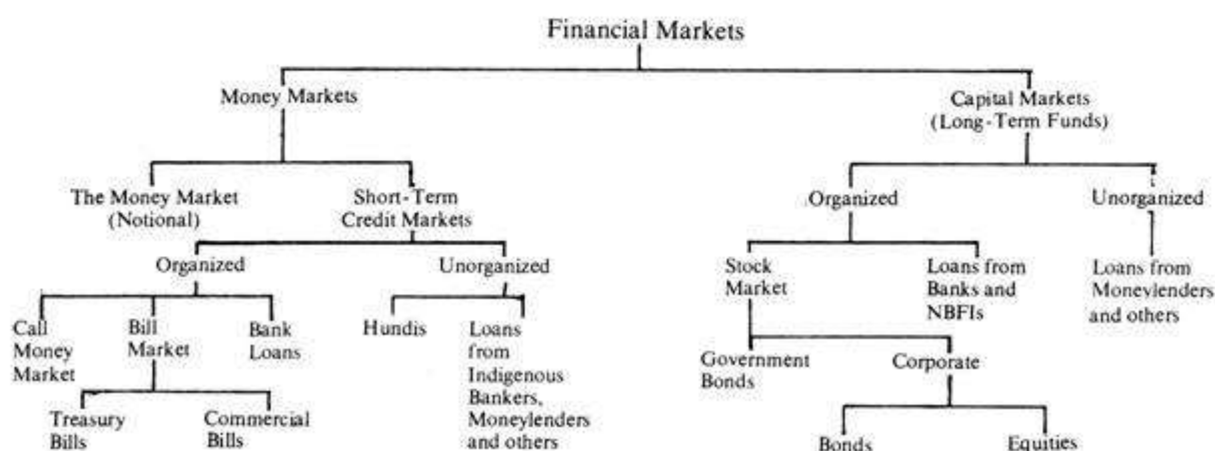
In this research paper we will study how financial markets play an important role in Indian Economy and methods to improve the financial markets.

Introduction-

A financial market is a market in which people trade financial securities and derivatives such as futures and options at low transaction costs. Securities include stocks and bonds and precious metals.

Classification of financial markets-

Figure 3.1
Functional-cum-Institutional Classification of Financial Markets



1. Capital Market: The capital market is one where long-term loans and equity capital are raised and exchanged. Banks, financial institutions, governments and companies raise funds for their long-term uses through the capital market. In terms of instruments and practices, the capital market can be broadly classified into the stock market and the bond market.

Stock market is further subdivided into

(i) Primary market, and

(ii) Secondary market.

The market which enables the companies to raise equity capital by issuing shares directly to the public and other investors is known as a primary market. Whereas, a secondary market is where securities like bonds, shares, derivatives are traded. Stock Exchanges generally represent the secondary market for exchange of shares and other securities. In the case of primary markets, no organised exchanges are necessary as the funds are raised by the government or the corporates directly from the public and other investors.

Bond markets deal with issue of debt contracts and the buying and selling of bonds and debentures.

2. Money Market: In a money market, banks lend to and borrow money from each other. In a general parlance, money market is defined as a market for instruments/ transactions with an initial maturity period of up to one year. In this market, banks and other financial institutions trade in securities/treasury bills and financial instruments such as certificate of deposits (CDs) or enter into agreements like repurchase agreements (Repos) and Reverse Repos. Money market functions either on an over-the-counter (OTC) system or a screen- based system. For the banks, one of the important money market instruments is call money/notice money. Call money or call deposit are those monies which are lent where the borrower has to repay the funds when called on to do so by the lender. On the other hand, notice money refers to those monies where the lender has to give an agreed number of days' notice to the borrower in order to repay the funds. In certain countries, the call/notice money refers to transactions for tenures ranging from overnight transactions to a maximum of 14 days.

However, a major portion of the transactions in the call market are for an overnight tenure, i.e., the borrower repays the principal along with the interest on the next day of the transaction. Banks normally use this market to manage their daily funding mismatches and to comply with their reserve stipulations like CRR and SLR.

Resorting to the call/notice money transactions is caused by a temporary mismatch of funds during the short period of 1 to 14 days, as the case may be. Those banks that have surplus lend money to adjust the mismatch for the relative period and those who are short of funds borrow for the relative period. The rate of interest is determined by the demand and supply of funds at a given point of time.

The placement of money/lending in the call/notice money market is not covered by any tangible security. As a prudential measure, therefore, each lender fixes a placement/ exposure limit for each borrower. This limit denotes the maximum amount a borrowing bank can borrow from the lending bank. The participating banks in the money market can also borrow and lend for a tenure greater than 14 days. This is known as Term Money.

Bill Rediscounting Scheme:

Banks, in their normal course of business, discount bills of exchange drawn by their customers or others. Bills of exchange emanate from genuine trade transactions between the buyer and the supplier. To provide liquidity to the banks, in many countries, there is a system of allowing the banks to avail of funds by rediscounting the bills discounted by them with either the central bank of the country or their designated agencies. Banks have to comply with the regulatory norms to avail of the facility under bill rediscounting scheme. This bills rediscounting facility augments the funds position of the banks.

Inter-Bank Participation Certificates (IBPCs):IBPC is yet another short-term money market instrument whereby the banks can raise and deploy funds. In case of IBPC, the borrowing bank sells the loans and credit that it has in its book for a temporary period to the lending bank. There are two types of IBPCs: (i) with risk sharing; and (ii) without risk sharing.

Generally, the funds are transacted under IBPC for a minimum period of 91 days and a maximum period of 180 days on risk sharing basis and, in case of IBPCs under non-risk sharing basis, the total period is limited to 90 days.

Repurchase Agreements (Repos):

Repo is a money market mechanism which enables collateralised short-term borrowing and lending through sale/purchase operations in debt instruments. Repo is not an instrument; rather, it is a process wherein a number of instruments such as G-Sec (Central/State Government Securities) and other stipulated bonds and instruments can be used as underlying securities to borrow and lend in the money market.

Under a repo transaction, a holder of securities sells them to an investor with an agreement to purchase back the same securities for the same amount on a pre-determined date. It is essentially a lending and borrowing transaction

at an agreed rate of interest known as Repo Rate. Upward/downward trend of the repo rate is an indicator for the interest rate to be given or charged by the banks in the near future.

A reverse repo is the mirror image of a Repo. A repo transaction viewed from the angle of the borrower is known as reverse repo. In a reverse repo, the securities acquired during a repo transaction are resold to the borrower.

Whether a transaction is a repo or a reverse repo is determined in terms of who initiated the first leg of the repo transaction. When the reverse repurchase commitment matures, the counter party returns the security to the borrowing bank concerned and receives its cash along with the profit spread. Repo transactions can also be undertaken with the central bank of the country.

Repo transaction can be undertaken for overnight to a longer term period. Repos are basically short-term instrument which can be used by the banks effectively for filling up short-term asset-liability gap of the bank or to meet short-term SLR requirements. A bank which is short on liquidity and holding surplus SLR securities can sell securities under repo and create liquidity for the short term, with an understanding to repurchase the same lot of securities on an agreed future date.

3. The Foreign Exchange (Forex) Markets:

In the forex market, the currencies of various countries are traded. Since a foreign currency cannot be used to settle a domestic transaction, currencies of various countries are traded in the market as if they are commodities. This market is liquid, particularly for the currencies like the US$, Japanese Yen, Euro, the UK Pound, Canadian Dollar, Australian Dollar, etc.The liquidity of the market is very high, as major international banks provide the market with both bid (buy) and ask (sell) offers on continuous basis. Major foreign exchange markets are located in New York, London, Paris, Hong Kong, Tokyo, Singapore and Frankfurt. This forex market is open 24 hours, throughout the week from Monday to Friday.

In view of the different time zones and geographical differences, it is seen that if the European market is closed the Asian market or the market in the United States will be open and because of this time zone differential, all the important currencies of the world are traded continuously.

The banks operating in the international markets borrow in the forex market located in various centres of the world, and use the funds in their overseas branches or for their domestic requirement. In order to use the funds borrowed in a particular currency in a country other than the home country of the currency, the banks are required to resort to a SWAP Deal for exchanging one currency into another.

Interest rate is determined by several factors and one of the most important interest codes is known as LIBOR (London Inter-bank Offer Rate). Similarly, there may be different rates being quoted by banks for lending and borrowing in difference centres of the world.

Besides the above centres, there are several other markets available in different countries from where commercial banks can borrow funds to meet their business requirements.

The three important functions of financial markets are:

i. Price discovery process which results from the interaction of buyers and sellers in the market when they trade assets.

ii. Provision of liquidity by providing a mechanism for an investor to sell financial assets, and

iii. Low cost of transactions and information.

Methods to improve financial markets-

.

1. **Money Market Development**

In the financial markets of a country, money market and capital market form important segments. Though these markets (capital and money markets) seem to have different characteristics and the instruments traded in these markets are totally different from each other, there is some kind of association among these markets. In India, as compared to the capital markets, money markets are lagging behind as far as diversification of products and accessibility to the investors are concerned. Normally, money market deals in short term funds while capital markets deal in long term funds. Though this is the fact, in European countries money markets are also developed and are more organized in nature and these markets are providing push to the capital markets whenever required. In India, money market has no much penetration among investors due to the reasons like limited access, lack of diversification etc. But money market along with debt market may have the ability to provide the help to the capital market. By increasing the market participants, relaxing the minimum investment requirement and providing a variety of products/services, the money market in India can be more organized and attractive, which would, in turn, provide the needed support to the capital market.

2. **Mergers of Stock Exchanges**

As on today, there are 19 stock exchanges in India. Initially, the number of stock exchanges was too low which was a hindrance for small shareholders to enter into the market. Gradually, especially after independence, the number of stock exchanges increased. The number touched a high of 23 stock exchanges in the year 2003. Now 4 regional stock exchanges have been derecognized by the SEBI and now there are 19 stock exchanges across the country. But it is interesting to note that more than 90 % of
22
the total turnover in the entire capital markets of a country takes place in the two premiere stock exchanges of the country viz. BSE and NSE. There are number of stock exchanges in India with very low turnover. Thus, these regional stock exchanges do not have a promising future. Due to the technological advancement and variety of products, NSE and BSE are the stock exchanges which are accessed by the investors across the country. Therefore, there is a strong need for merger of the regional stock exchanges. Due to this, the stock exchanges with lower turnover would be dissolved. For regional investors, there may not be much problem as they can have access to the other premiere stock exchanges in the country.

Another case in favour of mergers of stock exchanges is that only few and competent stock exchanges should prevail. Due to this, the problems like inefficiency, imperfect information, isolation may be automatically solved as these stock exchanges will be technologically advanced and competent to provide the state-of-the-art facilities to the investors and other players in the market. Similarly, there are very few companies which dominate the entire market. Therefore, these stock exchanges, which may be at distant locations, would be having less domination of big corporate players. One step in this direction i.e establishment of one stock exchange for MSMEs is in progress. For the regional and small investors, one stock exchange in a country with benches/counters in various regions can also be thought of. This would reduce regional imbalance, disparity and unjustified regional drains of capital.

3. **Deeper understanding of the functioning of Stock Exchanges**

Today, the capital markets are largely dominated by the domestic fund houses as well as FIIs. Thus, there is a little room for small and genuine investors to participate in the capital markets in a significant manner. Actually, it is expected that functioning of the capital markets should have resemblance with social, political and economic conditions of people in the country. Therefore, encouraging of stock exchanges' development needs attention to how the rules are formulated and implemented. Such

an institutional framework has to be evolved only after understanding of functioning of stock exchanges in much deeper manner. The inferences based on the aggregate data may lead to misjudgment. This may not result in the required policy prescriptions. The deeper understanding of functioning of stock exchanges would contribute to appropriate policy formation for the stock exchanges. This would, in turn, facilitate resource mobilization and thereby contribution of the capital markets to economic development of the nation.

Another important factor is that a time has come to decide whether due to dematerialization and quicker settlements, really the situation has improved or not. Some of the market players and speculators as well as FIIs are in search of quick returns. Therefore day trading has also emerged. With low delivery ratios (long term investments), it is evident that preference of market players is towards quick returns from investment. Therefore, role of Foreign Institutional Investors and domestic fund houses like mutual funds need to be watched carefully.

4. **Improvement in Participation by Middle and Low Income Group in the Capital Market**

Indian capital markets are dominated to a large extent by few big corporate houses and FIIs. Due to the excessive speculation forces prevailing in the market, small investors are keeping themselves away from the capital markets. These investors belong to middle and low income group. In order to improve the participation of these genuine investors, the need has arisen to have a task force consisting of officials from Ministry of Finance and Ministry of Company Affairs. This task force should come out with an action plan to spread the facilities of capital market to remote areas of the country. The stock exchanges should also involve themselves in investor education programme. Presently, this programme has very low success. Investors associations at various locations, educational institutions and the associations like Chamber of Commerce need to come together for investors' education programme. The apex bodies like SEBI need to monitor these programmes. Such programmes may involve imparting knowledge about stock exchanges, their functioning, significance of savings and investment, dematerialization, trading system and regulation. Such an exhaustive campaign can be launched initially at metropolitan areas. Then gradually, this can be percolated to municipal corporation area and then to the smaller towns and villages by arranging functions at critically important locations- mainly taluka places. The
24
researcher humbly suggests that educational institutions can play an important role in this aspect as they have presence throughout the country: in metros as well as in villages.

Though this requires a time to implement such programme, it would have better results in future. This would facilitate more resource mobilization by enhancing the rate of savings. Ultimately, this would also facilitate improvement in the participation by middle and low income group people where there are real and genuine investors. For further improvement of participation of small investors, the transaction cost involving demat charges, securities transaction tax and other charges need to be relaxed to some extent through which this class of people may be attracted towards the capital market.

Though SEBIs grievance redressal system is working properly, for regional investors, an idea of 'special investment court' can be thought of at district level or at a cluster of 2/3 districts. Most of the times, it is possible that complaints are not reported to SEBI as the people do not know the redressal mechanism. If such courts are located at district places, or near their towns, investors may feel free to lodge their complaints. These courts would also work within the guidelines/regulations of SEBI. This move, in turn, would enhance the confidence among the small investors who are located at different locations in various parts of the country.

5. **Improvement in Regulations and Serious Punishment to the Scamsters**

In the last two decades, more than 20 small and big scams took place out of which the

scams like Harshad Mehata scam, Ketan Parekh scam have had a deep impact on the stock markets. Most of the scams in the last two decades have not been disposed off. Therefore, some serious thought is necessary to restrict the frauds. There has to be a time- bound programme to complete the investigation of the frauds/scams. More attention should be paid on financial penalty to be imposed on the fraudulent players of the capital market. In such cases, personal property of these people and the funds misappropriated need to be attached and the same to be distributed among small/aggrieved investors. Now, SEBI has been assigned powers of an independent regulator, and it is working satisfactorily. But now since two decades of SEBI's existence are over, an evaluation of SEBI's functioning as a regulatory authority has to be done critically. Public debate on accountability, transparency, corporate governance, disclosures etc. need to be initiated. If needed after evaluation, SEBI's role and functioning can be made even more strict and accountable towards small investors. This would help in minimizing, though not completely abolishing the scams in the Indian capital markets. RBI, Dept. of Company Affairs, Ministry of Finance along with SEBI should come together to avoid overlapping of each other's role and thereby reducing the confusion among various investors as well as the regulators.

There is large number of companies with small or almost nil turnovers. These companies are still alive in stock exchanges like BSE and other regional exchanges. These companies are sold to the fraudulent promoters and scamsters. Such manipulated transfer need to be banned and restrictions be imposed on such activities. This would also minimize the abuse of small companies and risk associated with investment in small companies.

6. **ADR, GDR, IDR, and PN.Route**-

Since last decade or so, companies are using the weapons like American Depository Receipt (ADRs) Global Depository Receipts (GDRs), Indian Depository Receipts (IDRs) to raise the finance from the international capital markets. SEBI has taken a good step to ban PN-route of investment in Indian market. These participatory notes were allowed for investment in India markets without disclosing their source. Now time has come to closely monitor the investments made through ADRs, GDRs and IDRs. Review and evaluation of such investment with reference to the source of income, objective of investment and tenure of investment needs to be done carefully. Test checking and test audit of the companies using this route should be done. In this aspect, SEBI and RBI need to function with greater harmony. The money which comes in the market with suspicious source needs to be closely monitored.Similarly, it was also observed that the money which was coming in Indian markets from Mauritius had its origin in Indian investments in Mauritius with benami transactions. This is the reason why the sources of foreign investment have to be closely monitored, controlled and regulated.

7.**Towards the Future- Improvement in Efficiency of Markets**

Indian capital markets are not known for their efficiency in general. Due to the presence of insider trading, price rigging etc. the Indian markets lack efficiency. In order to test the efficiency, there is 'Efficient Market Hypothesis' which states that securities are normally in equilibrium and are 'fairly priced'. One cannot beat the market on account of his own trade. In such situation if there are really 'fair prices', it can be said that, markets are efficient. There are three aspects of EMH-

-Weak form EMH-

'One cannot profit by just looking at past trends of the market..'

Positive or negative trend of last few days may not assure the same or reverse trend in future. In most of the capital markets, this form prevails but still technical analysis is used to take decisions in the market.

-Semi-strong form EMH- 'All publicly available information is reflected in stock prices.' Thus, the annual reports, financial data of the companies help to price the securities correctly. This also holds good in many of the markets.

-Strong form EMH – 'All information even insider information, is reflected in stock prices.' This is a state of highly efficient markets, but practically this is far from reality.

In India the evidence supports semi strong form of EMH. Therefore, there is a room for improvement in efficiency in the markets. For this purpose, flow of information should be very fast and nobody should be able to have undue advantage of information access. All the market players should get the information at the same time irrespective of their location/ status. Though this is very stringent condition, and difficult to practically implement, the flow of information can be quicker. Announcing the relevant information (mandatory as well as non-mandatory) on the websites of the companies and the stock exchanges as well where these companies are listed. Similarly, the financial and economic journalists be provided the relevant information in time so as nobody can have advantage of 'early access.' The news channels, websites and newspapers are the media which have to be used effectively to improve the efficiency of the markets. Ultimately, this would result into dissemination of the requisite information to all the concerned without delay. Every player of the market should be able to access the information immediately when such information is disclosed. Nobody to have undue advantage. This would prohibit insider trading and thereby, facilitate and improve efficiency in the capital market.

8. **Integration of Indian and International Capital Markets**

Recently, the ups and downs in the prices of stocks have a large resemblance with global financial events. The subprime crisis which originated in the US market in the year 2008 had a negative impact on global financial markets and Indian markets were also not exception to that. Recently, in August 2011, when the reputed credit rating agency 'Standard and Poor (S&P)' reduced credit rating of the US from 'AAA' to 'AA+', there was again immediate downturn in the global markets. These are only few instances which prove that Indian markets are run not only by the indigenous investors, but they are susceptible to strong impact of global financial happenings also. This is particularly true because of opening of the economy. The investment in Indian market can be made by global players. Though there are few restrictions, due to the liberalization policy, Indian capital market has become an integral part of global markets. Earlier, Indian markets were isolated with almost zero impact of global events. But due to the new economic policy as well as the fact that Indian markets are one of the best emerging markets, more and more capital is being attracted in the Indian markets. But this money is also regarded as 'hot money' as it can go anywhere immediately. International agencies, FIIs are continuously in search of emerging 28 market and whenever they find another option, the capital invested by them may fly away from India quickly. This destabilizes the Indian markets.

Therefore, a cautious approach towards the role of FIIs and FFIs needs to be developed. If some concessions are given to them in taxes and costs, if they remain long term investors, this problem, to some extent, can be solved. Time and again, it has been proved that when FIIs enter into the market in a big way, retail investor look to exit. In order to protect the retail investors, a need of such cautious approach can be underlined. Further, the Committee on Capital Account Convertibility has also suggested a cautious approach while making rupee convertible on capital account. Firstly, the markets should be allowed to have efficiency. Secondly, there has to be strong domestic fund houses like mutual funds to compete with FIIs in the market. Finally, a large number of investors (indigenous/local) should be present in the market to absorb without severe losses the shocks given by the FFIs and FIIs. This would prove the purpose of investors' protection and at the same time, making the market competent and integrated with the international markets.

9. **Association with BRIC Markets to Absorb the Shocks**

Internationalization of the capital market has become inevitable in the days of globalization. Therefore, in order to keep the domestic market away from frequent shocks of global and especially European and American markets, there is a strong case

to get associated with emerging economies in general and BRIC economies in particular. India, along with Brazil, Russia and China has a globally respected market. But this market, many times, has proved to be vulnerable because of increasing presence of FIIs in the market. In order to have a check to this, there can be association of these economies with reference to their financial markets. All these emerging markets are competing with each other. Hence, all of them have an equal threat of 'hot money' which has a potential to cause vulnerability and instability. If the capital markets of all these countries have their own association, they can have better check on this 'flight' of capital. Similarly, FIIs would be left with very few options excluding these emerging markets.

Summary – Financial markets allow lenders to earn interest or dividend on their surplus invisible funds, thus contributing to the enhancement of the individual and national income. The government along with the SEBI should exercise regulatory authority and make stringent laws to curb illegal trading in financial markets keeping in view the welfare maximization of the public .

REFERENCES-

1. Wikipedia.org.in
2. www.investopedia.com
3. Ibef.org
4. Your article library.com
5. Shodhganga inflibinet.ac.in
6. www.Financial express.com
7. Money control.com