JETIR.ORG ISSN: 2349-5162 | ESTD Year : 2014 | Monthly Issue
JOURNAL OF EMERGING TECHNOLOGIES AND INNOVATIVE RESEARCH (JETIR)
An International Scholarly Open Access, Peer-reviewed, Refereed Journal

Context and Functions of Financial Market – A Study

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Abstract

This paper attempts to study how t**he equity and debt market** trades includes private placement sources of debt and equity as well as organized markets like stock exchanges form backbone of vibrant **Indian Financial markets.** Scarce resources are allocated to those firms which have the highest productivity for the economy. There are two major alternative mechanisms through which allocation of funds can be done: via banks or via financial markets. Households can deposit their surplus funds with banks, who in turn could lend these funds to business firms. Alternately, households can buy the shares and debentures offered by a business using financial markets. The process by which allocation of funds is done is called financial intermediation. Banks and financial markets are competing intermediaries in the financial system, and give households a choice of where they want to place their savings. Yields and Bond Prices are inversely related. So a rise in price will decrease the yield and a fall in the bond price will increase the yield. There will be an immediate and mostly predictable effect on the prices of bonds with every change in the level of interest rates.(The predictability here however refers to the direction of the price change rather than the quantum of the change) When the prevailing interest rates in the market rise, the prices of outstanding bonds will fall to equate the yield of older bonds with higher-interest rates of new issues. This will happen as there will be very few takers for the lower coupon bonds resulting in a fall in their prices. The prices would fall to an extent where the same yield is obtained on the older bonds as is available for the newer bonds. When the prevailing interest rates in the market fall, there is an opposite effect.

Key words: equity, debt, India, Capital Market, Financial markets

Introduction

They are an essential component of any portfolio of financial and real assets, whether in the form of pure interest-bearing bonds, varied type of debt instruments, or asset-backed mortgages, and securitised instruments. Fixed Income Markets - Powering the World The Fixed Income Securities market was the earliest of all the securities markets in the world and has been the forerunner in the emergence of the financial markets as the engine of economic growth across the globe. The Fixed Income Securities Market, also known as the debt market or the bond market, is easily the largest of all the financial markets in the world today in terms of market capitalisation.

The Debt Market has, as such, a very prominent role to play in the efficient functioning of the world financial system, and in catalyzing the economic growth of nations across the globe. Indian Debt Market - Pillars of the Indian Economy The Debt

Market plays a very critical role for any growing economy which needs to employ a large amount of capital and resources for achieving the desired industrial and financial growth. The Indian economy which has grown at more than 7% p.a. in the last decade and is on the take off stage for double digit growth would have to meet its resources requirements from a robust and an active debt market in India. The Government Securities market, called 'G-Sec' market, is the oldest and the largest component of the Indian debt market in terms of market capitalization, outstanding securities and trading volumes. The G-Secs market plays a vital role in the Indian economy as it provides the benchmark for determining the level of interest rates in the country through the yields on the government securities, which are referred to as the risk-free rate of return in any economy. Besides G-Sec market, there is an active market for corporate debt papers in India which trades in short term instruments, such as commercial papers and certificate of deposits issued by banks and long term instruments, such as debentures, bonds, zero coupon bonds and step up bonds. Wholesale Debt Market Segment (WDM) Government securities market, the largest and oldest component of Indian debt market, was a very active segment on BSE since the beginning of the 19th century.

Growth in the WDM The BSE WDM Debt Segment has shown a gradual but consistent growth in its turnover in the past few years, with increased participation from the mainstream banking and institutional players. This Segment expects a sustained rise in its turnover and participation, in the coming years, with the initiation of activity by the new members and continued support and participation of major Banks, Primary Dealers and financial institutions. Retail Debt Market Segment (RDM) The Retail Debt Market, in the new millennium, presents a vast kaleidoscope of opportunities for the Indian investor whose knowledge and participation hitherto has been restricted to the equity market. The development of the Retail Debt Market has engaged the attention of policy makers, regulators and the Government in the past few years.

Objective:

This paper intends to explore and analyze that with the recent economic reforms, an efficient and active **debt market, particularly in long-term private debt instruments,** is essential for the country to realize the full benefits of the reform process and to achieve full potential of **Indian Financial markets.**

Context and Functions of Financial Market

Financial markets play an important role in the allocation of scarce resources in an economy by performing the following four important functions.

1. Mobilisation of Savings and Channeling them into the most Productive Uses: A financial market facilitates the transfer of savings from savers to investors. It gives savers the choice of different investments and thus helps to channelise surplus funds into the most productive use.

2. Facilitating Price Discovery: You all know that the forces of demand and supply help to establish a price for a commodity or service in the market. In the financial market, the households are suppliers of funds and business firms represent the demand. The interaction between them helps to establish a price for the financial asset which is being traded in that particular market.

3. Providing Liquidity to Financial Assets: Financial markets facilitate easy purchase and sale of financial assets. In doing so they provide liquidity to financial assets, so that they can be easily converted into cash whenever required. Holders of assets can readily sell their financial assets through the mechanism of the financial market.

4.Reducing the Cost of Transactions: Financial markets provide valuable information about securities being traded in the market. It helps to save time, effort and money that both buyers and sellers of a financial asset would have to otherwise spend to try and find each other. The financial market is thus, a common platform where buyers and sellers can meet for fulfillment of their individual needs. Financial markets are classified on the basis of the maturity of financial instruments traded in them. Instruments with a maturity of less than one year are traded in the money market. Instruments with longer maturity are traded in the capital market.

Money Market Instruments

1. Treasury Bill: A Treasury bill is basically an instrument of short-term borrowing by the Government of India maturing in less than one year. They are also known as Zero Coupon Bonds issued by the Reserve Bank of India on behalf of the Central Government to meet its short-term requirement of funds. Treasury bills are issued in the form of a promissory note. They are highly liquid and have assured yield and negligible risk of default. They are issued at a price which is lower than their face value and repaid at par. The difference between the price at which the treasury bills are issued and their redemption value is the interest receivable on them and is called discount. Treasury bills are available for a minimum amount of `25,000 and in multiples thereof. Example: Suppose an investor purchases a 91 days Treasury bill with a face value of ` 1,00,000 for `96,000. By holding the bill until the maturity date, the investor receives `1,00,000. The difference of `4,000 between the proceeds received at maturity and the amount paid to purchase the bill represents the interest received by him.

2. Commercial Paper: Commercial paper is a short-term unsecured promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is issued by large and creditworthy companies to raise short-term funds at lower rates of interest than market rates. It usually has a maturity period of 15 days to one year. The issuance of commercial paper is an alternative to bank borrowing for large companies that are generally considered to be financially strong. It is sold at a discount and redeemed at par. The original purpose of commercial paper was to provide short-terms funds for seasonal and working capital needs. For example companies use this instrument for purposes such as bridge financing. Example: Suppose a company needs long-term finance to buy some machinery. In order to raise the long term funds in the capital market the company will have to incur floatation costs (costs associated with floating of an issue are brokerage, commission, printing of applications and advertising, etc.). Funds raised through commercial paper are used to meet the floatation costs. This is known as Bridge Financing.

3. Call Money: Call money is short term finance repayable on demand, with a maturity period of one day to fifteen days, used for inter-bank transactions. Commercial banks have to maintain a minimum cash balance known as cash reserve ratio. The Reserve Bank of India changes the cash reserve ratio from time to time which in turn affects the amount of funds available to be given as loans by commercial banks. Call money is a method by which banks

Capital Market

The term capital market refers to facilities and institutional arrangements through which long-term funds, both debt and equity are raised and invested. It consists of a series of channels through which savings of the community are made available for industrial and commercial enterprises and for the public in general. It directs these savings into their most productive use leading to growth and development of the economy. The capital market consists of development banks, commercial banks and stock exchanges. An ideal capital market is one where finance is available at reasonable cost. The process of economic development is facilitated by the existence of a well functioning capital market. In fact, development of the financial system is seen as a necessary condition for economic growth. It is essential that financial institutions are sufficiently developed and that market operations are free, fair, competitive and transparent. The capital market should also be efficient in respect of the information that it delivers, 695inimize transaction costs and allocate capital most productively.

Primary Market

The primary market is also known as the new issues market. It deals with new securities being issued for the first time. The essential function of a primary market is to facilitate the transfer of investible funds from savers to entrepreneurs seeking to establish new enterprises or to expand existing ones through the issue of securities for the first time. The investors in this market are banks, financial institutions, insurance companies, mutual funds and individuals. A company can raise capital through the primary market in the form of equity shares, preference shares, debentures, loans and deposits. Funds raised may be for setting up new projects, expansion, diversification, modernisation of existing projects, mergers and takeovers etc.

Methods of Floatation There are various methods of floating new issues in the primary market :

1. Offer through Prospectus: Offer through prospectus is the most popular method of raising funds by public companies in the primary market. This involves inviting subscription from the public through issue of prospectus. A prospectus makes a direct appeal to investors to raise capital, through an advertisement in newspapers and magazines. The issues may be underwritten and also are required to be listed on at least one stock exchange. The contents of the prospectus have to be in accordance with the provisions of the Companies Act and SEBI disclosure and investor protection guidelines.

2. Offer for Sale: Under this method securities are not issued directly to the public but are offered for sale through intermediaries like issuing houses or stock brokers. In this case, a company sells securities enbloc at an agreed price to brokers who, in turn, resell them to the investing public. 3. Private Placement: Private placement is the allotment of securities by a company to institutional investors and some selected individuals. It helps to raise capital more quickly than a public issue. Access to the primary market can be expensive on account of various mandatory and non-mandatory expenses. Some companies, therefore, cannot afford a public issue and choose to use private placement.

Steps in the Trading and Settlement Procedure

It has been made compulsory to settle all trades within 2 days of the trade date, i.e., on a T+2 basis, since 2003. Prior to the reforms, securities were bought and sold, i.e., traded and all positions in the stock exchange were settled on a weekly/ fortnightly settlement cycle whether it was delivery of securities or payment of cash. This system prevailed for a long time as it increased the volume of trading on the exchange and provided liquidity to the system. However, since trades were to be settled on specified dates, this gave rise to speculation and price of shares used to rise and fall suddenly due to trading and defaults by brokers. A new system, i.e, rolling settlement, was introduced in 2000, so that whenever a trade took place it would be settled after some days. Since 2003, all shares have to be covered under the rolling settlement system on a T+2 basis, meaning thereby that transactions in securities are settled within 2 days after the trade date. Since rolling settlement implies fast movement of shares, it requires effective implementation of electronic fund transfer and dematerialisation of shares. The following steps are involved in the screen-based trading for buying and selling of securities:

1.If an investor wishes to buy or sell any security he has to first approach a registered broker or sub-broker and enter into an agreement with him. The investor has to sign a broker-client agreement and a client registration form before placing an order to buy or sell securities.

2.The investor has to open a 'demat' account or 'beneficial owner' (BO) account with a depository participant (DP) for holding and transferring securities in the demat form. He will also have to open a bank account for cash transactions in the securities market.

3.The investor then places an order with the broker to buy or sell shares. Clear instructions have to be given about the number of shares and the price at which the shares should be bought or sold. The broker will then go ahead with the deal at the above mentioned price or the best price available. An order confirmation slip is issued to the investor by the broker.

4.The broker then will go on-line and connect to the main stock exchange and match the share and best price available.

5.When the shares can be bought or sold at the price mentioned, it will be communicated to the broker's terminal and the order will be executed electronically. The broker will issue a trade confirmation slip to the investor.

6.After the trade has been executed, within 24 hours the broker issues a Contract Note. This note contains details of the number of shares bought or sold, the price, the date and time of deal, and the brokerage charges. This is an important document as it is legally enforceable and helps to settle disputes/claims between the investor and the broker. A Unique Order Code number is assigned to each transaction by the stock exchange and is printed on the contract note.

7.Now, the investor has to deliver the shares sold or pay cash for the shares bought. This should be done immediately after receiving the contract note or before the day when the broker shall make payment or delivery of shares to the exchange. This is called the pay-in day.

8.Cash is paid or securities are delivered on pay-in day, which is before the T+2 day as the deal has to be settled and finalised on the T+2 day. The settlement cycle is on T+2 day on a rolling settlement basis, w.e.f. 1 April 2003.

9.On the T+2 day, the exchange will deliver the share or make payment to the other broker. This is called the pay-out day. The broker then has to make payment to the investor within 24 hours of the pay-out day since he has already received payment from the exchange.

10.The broker can make delivery of shares in demat form directly to the investor's demat account. The investor has to give details of his demat account and instruct his depository participant to take delivery of securities directly in his beneficial owner account.

Depository

Just like a bank keeps money in safe custody for customers, a depository also is like a bank and keeps securities in electronic form on behalf of the investor. In the depository a securities account can be opened, all shares can be deposited, they can be withdrawn/ sold at any time and instruction to deliver or receive shares on behalf of the investor can be given. It is a technology driven electronic storage system. It has no paper work relating to share certificates, transfer, forms, etc. All transactions of the investors are settled with greater speed, efficiency and use as all securities are entered in a book entry mode. In India, there are two depositories. National Securities Depositories Limited (NSDL) is the first and largest depository presently operational in

India. It was promoted as a joint venture of the IDBI, UTI, and the National Stock Exchange. The Central Depository Services Limited (CDSL) is the second depository to commence operations and was promoted by the Bombay Stock Exchange and the Bank of India. Both these national level depositories operate through intermediaries who are electronically connected to the depository and serve as contact points with the investors and are called depository participants. The depository participant (DP) serves as an intermediary between the investor and the Depository (NSDL or CSDL) who is authorised to maintain the accounts of dematerialised shares. Financial institutions, banks, clearing corporations, stock brokers and non-banking finance corporations are permitted to become depository participants. If the investor is buying and selling the securities through the broker or the bank or a non-banking finance corporation, it acts as a DP for the investor and complete the formalities.

Conclusion

Financial Market is a market for creation and exchange of financial assets. It helps in mobilisation and channelising the savings into most productive uses. Financial markets also helps in price discovery and provide liquidity to financial assets. Money Market is a market for short-term funds. It deals in monetory assets whose period of maturity is less than one year. The instruments of money market includes treasury bills, commercial paper, call money, Certificate of deposit, commercial bills, participation certificates and money market mutual funds. Capital Market is a place where long-term funds are mobilised by the corporate undertakings and Government. Capital Market may be devided into primary market and secondary market. Primary market deals with new securities which were not previously tradable to the public. Secondary market is a place where existing securities are bought and sold.

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