

# INTRODUCTION TO FINANCIAL MARKETS

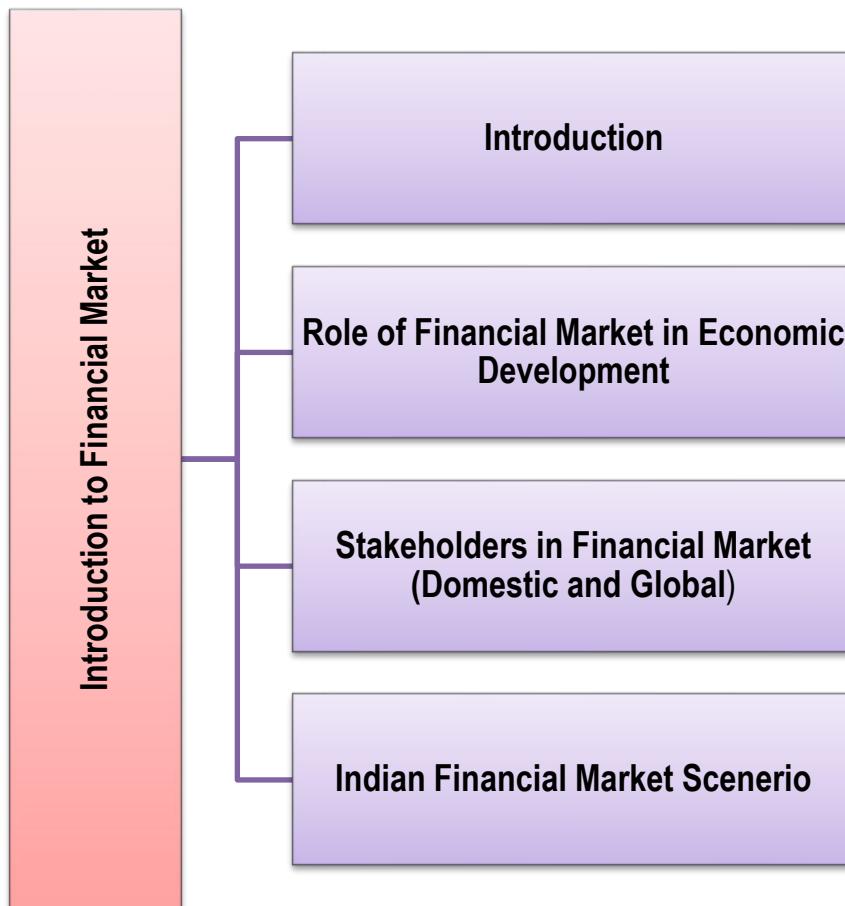


## LEARNING OUTCOMES

**After going through the chapter student shall be able to understand:**

- Introduction to Financial Markets
- Role of Financial Market in Economic Development of a country
- Stakeholders in Financial Market (Domestic and Global)
- Indian Financial Market Scenario

## CHAPTER OVERVIEW





## 1. INTRODUCTION TO FINANCIAL MARKETS



Financial markets are a marketplace that provides an avenue for the sale and purchase of financial assets such as equity stocks, bonds, foreign exchange, commodities, derivatives, etc.

### 1.1 Major types of financial markets

#### 1.1.1 Stock market

The stock market is the market for trading in equity stocks of companies. Typically, dividend yield in stocks is on the lower side, as dividend is declared as a percentage of the face value of the stock whereas the price in the secondary market runs up. That is, as a percentage of market price, the return to the investor is on the lower side. Gains come from capital price appreciation in the secondary market. This market is volatile, as the price in the secondary market reflects expectations going forward on the economy and corporate earnings.

#### 1.1.2 Bond market

The bond market offers an avenue for companies and the government to raise money to finance a project or a deficit, with a defined repayment timeline. In a bond market, investors buy bonds from a company, and the company returns the amount of the bonds on the stipulated date, along with the coupon or interest payment as agreed.

### 1.1.3 Commodities market

The commodities market is a market where traders and investors buy and sell natural resources or commodities such as corn, oil, pulses, meat, gold, etc. Prices for goods that will be delivered at a specific future date are determined in the present on the commodities future market.

### 1.1.4 Currency Markets

The currency market is a market for traders of currencies. It is a boon to the importers and exports and others having foreign currency exposure. It provides the opportunity for participants to hedge their currency exposures, provides depth to the market, making cross currency transactions and hedging a reality.

### 1.1.5 Money Market

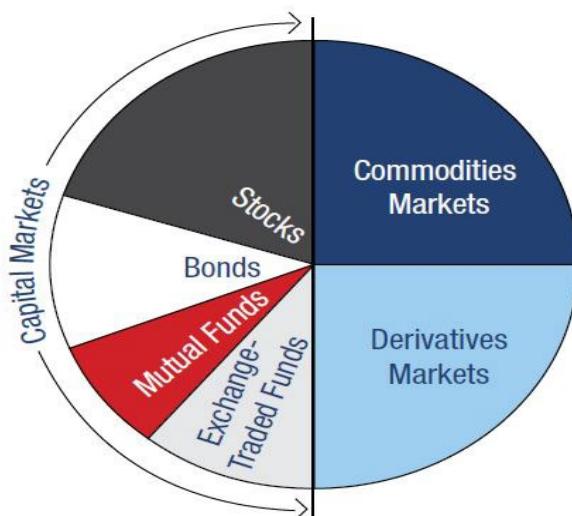
- ◆ It is a market for short term source of funds.
- ◆ Money market instruments have maturity of less than 1 year.
- ◆ The basic objective is to manage liquidity in the economy.
  
- ◆ The RBI along with other commercial banks are the key players in this market.
- ◆ It plays an important part in controlling inflation.

### 1.1.6 Derivatives market

This market deals in derivatives or contracts whose value is based on the market value of the asset being traded, called the underlying. The commodities futures mentioned above are an example of a derivative. Currency and equity derivatives are popular. Further, according to one study, India and China top the world's commodity market.



**Source:** <https://www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1351027541272>



## 1.2 Importance of Financial Markets

There are many social benefits that financial markets facilitate, including:

- ◆ They provide individuals, companies, governments, and quasi-government organizations access to capital.
- ◆ People with surplus funds for investment get channels for investment and are assured of fair treatment as there is a regulator i.e., transfer of funds from surplus units to deficit units. For instance, people with extra money access the stock market despite being aware of the risk inherent in it as they look for higher return and assured of transparency in the market because of the presence of SEBI.

- ◆ Financial markets create jobs as there are many people involved in direct and indirect activities. For instance, the involvement of the brokers, underwriters, merchant bankers, custodians, depositories etc. in the financial markets.

### 1.3 Size of the Global Financial Market

The biggest markets are those of derivatives, though conventionally we tend to think of Equity or Bond markets as large. Globally, derivatives markets are much more developed.



Source: Google to <https://topforeignstocks.com/2011/08/23/how-big-is-the-global-financial-industry/>

The chart above shows that the notional amount of financial derivatives outstanding is much higher than the traded volume of stocks and bonds.



## 2. ROLE OF FINANCIAL MARKET IN ECONOMIC DEVELOPMENT OF A COUNTRY

For economic development, a country needs capital, and the capital markets discussed above e.g., equities, bonds, etc. channelize those resources. Through the financial market or capital market system, funds flow from those who have surplus funds to those who have a shortage of funds, either by direct, market-based financing or by indirect, bank-based finance. Without a properly functioning stock market, price discovery of corporations would not happen and resource mobilization through IPOs would be hampered. How a financial market helps to boost an economic of a country has been highlighted in the following points:

- The financial market is a mode of channelizing savings to investments.
- It helps in creating more capital for the industries.
- Which in turn creates more jobs because of the increase in production.
- More jobs increase the standard of living which leads to more demand for goods and services.
- Which further leads to more capex and the process goes on.
- Further this process helps generate more taxes for the Government.
- More tax collection facilitates more spending by the Government.
- Which in turn creates more jobs and more demand again.
- And the process goes on.

## 2.1 Functions of Financial Markets

The role of financial markets in the success and strength of an economy is immense. Some important functions of financial markets are:

✓ **Puts savings into more productive use**

Money in the savings account should be put to productive use. Financial institutions like banks loan it out to individuals and companies that need it for say home loan, study loan, business purposes, big projects, etc. Further, savings as such do not have any meaning; it is investment that puts it to productive use.

✓ **Determines the price of securities**

Once a security is listed, buyers and sellers trade in it, and the traded price reflects the prospects of the company whose instruments are being traded. This is called price discovery. Prices of securities are determined in financial markets, which is an important function.

✓ **Makes financial assets liquid**

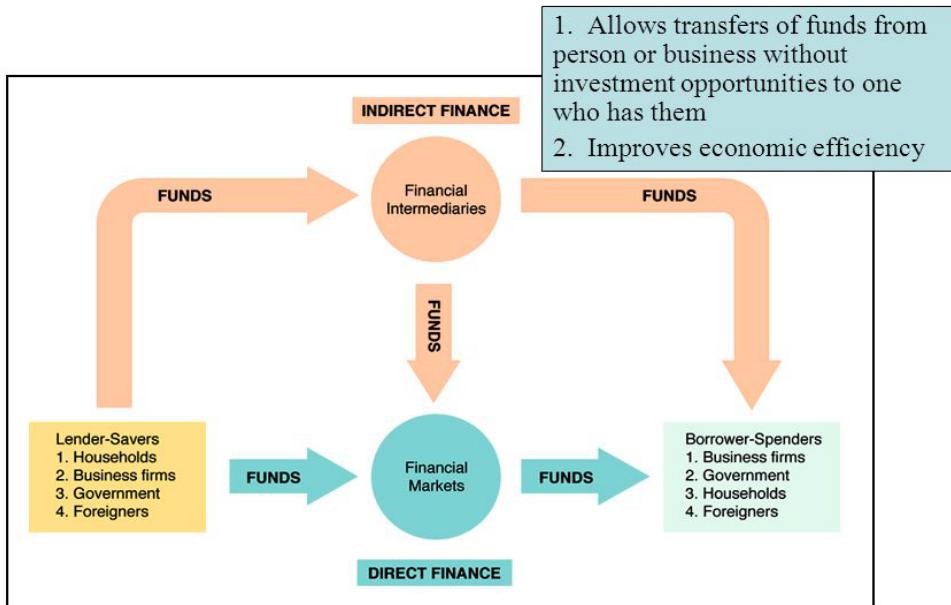
Buyers and sellers can decide to trade their securities anytime, provided there is a counterpart. Financial markets provide this avenue, and that creates liquidity in the security. This imparts liquidity to investors and incentivizes them to invest.

✓ **Lowers the cost of transactions**

In financial markets, various types of information regarding securities can be acquired without the need to spend. The Exchanges and market participant associations disseminate relevant

information. The companies also can disseminate information, but they would put forth only what they want to propagate, not what is useful for investors.

## Function of Financial Markets



Source: Google to <https://slideplayer.com/slide/5737595/>

Financial markets facilitate the flow of savings and investment in the economy for generation of capital and the production of goods and services.

### 2.2 The linkages in financial flows

As we see in the diagram above, households save and invest through financial institutions. Apart from households, the corporate or business sectors also may have surplus from time to time, which is invested through financial institutions. For economic development of a country, the business sector and the government need resources, which are mobilized by the financial institutions and markets? The government may need to borrow from the market, which is facilitated by financial markets. Resources may be mobilized from abroad as well, depending on the relative growth potential of the two economies.

The resources, i.e., funds, are deployed in the real economy by the government and private sector business firms, for creation of capacities and for running the wheel i.e., necessary revenue expenditure. The production of business firms is consumed by the household sector. Government

taxes are collected from the business sector. Economic development happens through increasing the size of the pie shown above, which is denoted by the GDP growth rate, by generating efficiencies in the production process and increasing the speed of the cycle. While generating efficiencies is the job of the participants in the production process, the resource that moves the wheel is finance.

Financial markets provide this resource. It must be done at an optimum cost; it should be low enough to incentivize producers to raise resources and high enough for households to save. The more efficient financial markets are, the more efficient is this process of price discovery.

### 2.3 Contribution of market to economy

The state of development of the financial markets reflects the state of development of the economy, and vice versa. It is a relationship of symbiosis, as the market and the economy feed from each other.

*According to Baily and Elliott, there are three major functions of the financial system:*

**Credit Provision** - Credit supports economic activity. Governments can invest in infrastructure projects by reducing the cycles of tax revenues and correcting spends, businesses can invest more than the cash they have, and individuals can purchase homes and other utilities without having to save the entire amount in advance. Banks and other financial service providers give this credit facility to all stakeholders.

**Liquidity provision** - Banks and other financial providers protect businesses and individuals against sudden cash needs. Banks provide the facility of demand deposits which the business or individual can withdraw at any time. Similarly, they provide credit and overdraft facilities to businesses. Moreover, banks and financial institutions offer to buy or sell securities as per need and often in large volumes to fulfill sudden cash requirements of the stakeholders.

**Risk management services** - Finance provides risk management from the risks of financial markets and commodity prices by pooling risks. Derivative transactions enable banks to provide this risk management. These services are extremely valuable even though they receive a lot of flak due to excesses during financial crisis.

According to Global Financial Development Report of World Bank of 2014, “Fundamentally, financial sector development concerns overcoming “costs” incurred in the financial system. This process of reducing costs of acquiring information, enforcing contracts, and executing transactions results in the emergence of financial contracts, intermediaries, and markets. Different types and combinations of information, transaction, and enforcement costs in conjunction with different regulatory, legal and

tax systems have motivated distinct forms of contracts, intermediaries, and markets across countries in different times.”

According to Levine, “The five key functions of a financial system in a country are: (i) information about possible investments and capital allocation; (ii) monitoring investments and the exercise of corporate governance after providing financing; (iii) facilitation of the trading, diversification, and management of risk; (iv) mobilization and pooling of savings; and (v) promoting the exchange of goods and services.”



### **3. STAKEHOLDERS IN FINANCIAL MARKET (DOMESTIC AND GLOBAL)**

Various stakeholders in the financial market can be categorized into following four segments:

**(i) Primary stakeholders in financial market**

- ❖ Shareholders
- ❖ Lenders
- ❖ Companies
- ❖ Mutual fund Organizations/holders/fund managers

**(ii) Service providers in financial market**

- ❖ Merchant Bankers
- ❖ Brokers
- ❖ Underwriters
- ❖ Depositories
- ❖ Custodians

**(iii) Regulators in financial market**

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

**(iv) Administrators to facilitate the financial market**

- ❖ Association of Mutual funds of India (AMFI)
- ❖ Foreign Exchange Dealers Association of India (FEDAI)
- ❖ Fixed Income Money Market and Derivative Association of India (FIMMDA)
- ❖ Association of Investment Bankers of India (AIBI)

### (i) Primary stakeholders in financial market

(a) **Shareholders:** In simple language, shareholders are the owners of a company. So, a shareholder is any person such as an individual, company or other institution who holds at least one share out of the company's total shares. As shareholders are owners of the company, they benefit when the share prices increase. In the same way, the shareholders lose out when the company's shares plummet.

The shareholders participate in the financial market (secondary market) by buying and selling shares. Their actions depend upon which way the market is behaving. If the market price is low, they tend to buy more shares. On the other hand, if the market price of shares is high, they will sell more shares to make a profit. Thus, they provide the much-needed liquidity in the stock market.

(b) **Lenders:** A lender in relation to a financial market is either a company or any other form of corporation that issues bonds or debentures to make its end meet. Funds are available to another with the expectation that the funds will be repaid, in addition to any interest and/or fees, either in increments or as a lump sum. They also provide the much-needed liquidity in the financial market by facilitating the flow of funds from deficit spending to surplus spending sectors.

(c) **Corporates:** Corporates raise money either through the share market route or through the bond market route. Raising money by issuing shares to the public generally helps the companies to amass huge amounts of capital. It keeps the financial market ticking by enabling mobilization and allocation of saving from the people, be it, individual investors, companies, and institutional investors whether foreign or domestic.

However, raising equity share capital has its repercussions. The cost of equity share capital is costly. Moreover, companies must meet a lot of regulatory compliances at the time of initial public offerings which takes a lot of time, energy, and money. But, if the company managed to keep its share prices on the higher side, it will easily get more funds in the future whether through equity or debt. If the company opting to raise funds through the debt route, it has certain advantages and disadvantages. The benefits are lower cost of capital in comparison

to equity. The debt route also tends to increase the earnings per share (EPS) of the company which consequently leads to escalation of share prices of the company. However, the demerit is that a debt must be repaid along with interest. So, too much debt may lead an organization to financial/default risks and may land it in financial distress.

- (d) **Mutual fund Organizations:** A mutual fund is a financial institution or intermediary that pools the savings of investors for collective investment in a diversified portfolio of securities. A fund is 'mutual' as all its returns, minus its expenses, are shared by the fund's investors. A mutual fund serves as a link between the investor and the securities market by mobilizing savings from the investor and investing them in the securities market to generate returns.

(ii) **Service providers in financial market**

- (a) **Merchant Bankers:** As per the Securities and Exchange Board of India (Merchant Banker) Regulations, 1992, merchant banker means any person who is engaged in the business of issue management, either by making arrangements regarding selling, buying, or subscribing to securities, or acting as a manager, consultant, or advisor, or rendering corporate-advisory services in relation to such issue management. It is mandatory to appoint a merchant banker in case of a public issue. The functions of merchant banker include – submitting offer documents to SEBI, due diligence i.e., certifying that all the disclosures made in the draft prospectus or letter of offer are true and fair and will enable the investors to make an informed decision etc.

**Globally**, merchant bankers play the same role as discussed above. Some of the top Merchant Bankers in USA are Merrill Lynch, Citigroup, Goldman Sachs, J.P. Morgan, and Morgan Stanley. They provide services to top companies in the world. For example, Morgan Stanley has been responsible for hundreds of technology financing and M&A transactions aggregating over \$500 billion in value. Further, Goldman Sachs has served all the big names in tech, including Microsoft, Apple, Facebook, Twitter, Ebay and Alibaba.

- (b) **Brokers:** Stockbrokers participate in the stock market on behalf of their clients. They buy and sell shares on behalf of the clients on their instructions. To actively participate in the capital market, they should be SEBI registered. So, they facilitate trading in the stock market (secondary market) by undertaking buys and sell transactions on behalf of the client.

**In the USA**, most "brokers" must be registered with the Securities Exchange Commission (SEC) and join a "self-regulatory organization," or SRO. Globally, margin financing is popular, in which, many large broking houses provide financing facilities to clients who borrow money

to invest in stocks. Therefore, Stock exchanges monitor the extent to which brokers are lending in line with their net worth.

- (c) **Underwriters:** Underwriters are those people who assume the risk of others. In the capital market, in case of new issues, they assume risk by guaranteeing that in case the shares are not subscribed fully by the public, the unsubscribed portion will be subscribed by the underwriter itself. They do it by charging a small fee.

So, how do the underwriters make profit? They buy the shares of the company before they are listed on a stock exchange. The underwriters make their profit on the difference in price between what they paid before the IPO and when the shares are offered to the public.

- (d) **Depositories:** Depository is an institution which maintains investors account in electronic form. One of the main functions of the Depository is to transfer the ownership of shares from one investor to another whenever the trading of shares takes place. It helps in reducing the paperwork involved in trade, expedites the transfer, and reduces the risk associated with physical shares such as damage, theft, and subsequent misuse of the certificates or fake securities.

There are two types of depositories in India which are known as NSDL (National Securities Depository Limited) and CDSL [Central Depository Services (India) Limited]. They interface with the investors through their agents called Depository participants (DPs). DPs could be the banks (private, public, and foreign), financial institutions or SEBI registered trading members.

**Globally**, depositories provide the same set of services as has been rendered by CDSL and NSDL.

- (e) **Custodians:** Custodians provide custodial services for safe keeping of securities. Besides safe keeping, they provide other services for a fee (generally 1% of the total volume of transactions) such as physical transfer of share certificates, collecting dividends and interest warrants and conforming to transfer regulations. Besides that, it also updates client status on their investment status. Even though securities are in the custody of depositories, the custodians act as a complementary to them by providing various services as mentioned above. In India, The Stock Holding Corporation of India (SHCIL) and the SBI Share Holding Corporation are the leading custodians.

After liberalization in 1991, **foreign institutional investors (FIIs)** were allowed to invest in the Indian Capital Market. Most of the FII business in India is routed through foreign custodians. According to US laws, no US fund is allowed to use a custodian that does not

have a capital adequacy of USD 200 million. No Indian custodian meets this requirement. Therefore, only foreign banks operate as custodians for US based FIIs, pension funds, and corporates. Hong Kong Bank, Deutsche Bank, Citi Bank, and Standard Chartered Bank are some leading foreign banks which operate as custodians.

### (iii) Regulators in financial market

- (a) **Securities and Exchange Board of India (SEBI):** SEBI was born in 1992. The basic objective was to protect the interest of investors in securities and promote the development of the securities market. The important objectives of SEBI are:
- Protect the interest of investors in securities.
  - Promotes the development of securities market.
  - Regulating the securities market.

#### Major Roles of SEBI

- Regulate the Business in Securities Exchanges.
- Register & Regulate intermediaries, collective investment schemes (including Mutual Funds).
- Promote & regulate SRO's. (Self-Regulatory Organizations)
- Prohibit unfair & fraudulent trade practices.
- Promote investor education & Training
- Prohibit Insider trading.
- Regulate substantial acquisition of shares & takeover of companies
- Inspection/Audit of intermediaries & SRO's.
- Any other function as provided under the SCRA 1956, as delegated by the govt.

**Outside India:** Securities Exchange Commission (SEC) in USA performs more or less the same functions as given to SEBI. But the stark difference is the amount of penalty. SEC can impose an unlimited amount of fine which SEBI cannot. That is the reason SEC has more teeth in comparison to SEBI and acts as an effective deterrent against malpractices in the stock market.

- (b) **Reserve Bank of India:** The Reserve Bank of India was established in 1935 with the provision of Reserve Bank of India Act, 1934. Though privately owned initially, in 1949 it was

nationalized and since then fully owned by Government of India (GoI). The preamble of the Reserve Bank of India describes its main functions as to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage, RBI is Apex body for regulation of Banking Sector, Controls money supply in India, Banker to Government and banker to banks, Responsible for monetary and fiscal policy, Regulates the debt securities of Government and forex markets.

**Outside India:** Federal Reserve (Fed) in the USA's policies is primarily driven by growth and employment figures, at the expense of inflation. On the other hand, we have the RBI, whose policies are primarily driven by inflation, at the expense of growth. So which approach is better depending upon the situation of the economy. In the USA and European Union, where the rate of interest is very low encourages industry to borrow at cheaper cost and contributes towards economic development and growth. However, in India, the aim of RBI is to keep the rate of interest high to discourage the industry to borrow large amount of money and consequently to contain inflation.

However, recently, due to the Covid-19 pandemic, RBI has lowered the interest rates to give a firm push to the dwindling economic growth, but not by much. The reason is that too much lowering of interest rates will give not contain the rising inflation rate. So, what is the way out to keep interest rates low and bring them down further?

One solution is - given the prevailing environment, more proactive bond purchases will be required over a longer period of time to provide support to the bond market and the overall economy. Bank credit growth is expected to rise in the coming quarters even though NBFCs are likely to stay in consolidation mode. Banks are unlikely to be able to support both private credit demand and higher borrowings simultaneously. In this backdrop, the RBI needs to step in proactively to buy bonds and keep longer duration yields from inching higher.

- (c) **Insurance Regulatory and Development Authority of India (IRDAI):** IRDA Act was passed in 1999. The main aim of the Insurance Regulatory and Development Authority of India is to protect the interest of holders of Insurance policies to regulate, promote and ensure orderly growth of Insurance industry & for matters connected therewith or incidental thereto. Under this Act, Controller of Insurance under Insurance Act, 1938 was replaced by newly established authority called Insurance Regulatory and Development Authority (IRDA).

**Outside India:** In USA, insurance is almost regulated by the individual state governments. In Canada, Office of the Superintendent of Financial Institutions Canada (OSFI) sets the minimum regulatory requirements and expectations to support policyholder and creditor

protection, giving due regard to the need to allow institutions to compete effectively. As healthy companies are in the best position to protect policyholders and creditors, OSFI is aware of the impact of its requirements and expectations on competition domestically and internationally.

Insurance regulators in other jurisdictions pursue similar goals but with different legislative and policy tools and with different economic experiences and conditions. OSFI considers the pace, scope and impact of reforms while renewing the regulatory framework ensures that we can incorporate best practices, and limit – to the extent practical – unintended consequences and an uneven playing field.

(Source: *Office of the Superintendent of Financial institutions, Canada*)

- (d) **Pension Fund Regulatory and Development Authority (PFRDA):** The objective of PFRDA is to be a model Regulator for promotion and development of an organized pension system to serve the old age income needs of people on a sustainable basis. Pension systems throughout the world have been under scrutiny over the last couple of decades. Numerous reforms have been carried out to tackle the sustainability and adequacy of pension arrangements in the face of the rising global demographic challenge.

**Outside India:** The main law which governs the establishment, maintenance, and termination of pension plans in the United States is the Employee Retirement Income Security Act (ERISA).

Prudential supervision of Australian pension funds started in 1993. The objective of the regulation regarding superannuation aimed at reducing the riskiness of superannuation investments, dealing with retirement incomes policy, equal treatment of members and various other matters.

**(iv) Administrative authorities to facilitate the financial market**

- (a) **Association of Mutual funds of India (AMFI):** The Association of Mutual Funds of India (AMFI) is dedicated to developing the Indian Mutual Fund Industry on professional, healthy and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of mutual funds and their unit holders.

AMFI, the association of SEBI registered mutual funds in India of all the registered Asset Management Companies, was incorporated on August 22, 1995, as a non-profit organization. As of now, all the 42 Asset Management Companies that are registered with SEBI are its members.

### Roles of AMFI

- It is an advisory body for mutual funds.
- It represents Mutual Fund (MF) industry before the Government.
- All Asset Management Companies (AMCs) are members of AMFI.
- It gives information about all the Mutual Fund schemes on its website.
- It is also responsible for framing code of conduct and ethics for AMCs.

**The Mutual Fund Dealers Association of Canada (MFDA)** is the national self-regulatory organization (SRO) that oversees mutual fund dealers in Canada. The MFDA was established in mid-1998 at the initiative of the Canadian Securities Administrators (CSA) in response to the rapid growth of mutual funds in Canada in the late 1980s from \$40 billion to \$400 billion and recognition by the CSA that the mutual fund industry and investors would benefit from more effective regulation and oversight. As an SRO, the MFDA is responsible for regulating the operations, standards of practice and business conduct of its members and their representatives with a view to enhancing investor protection and strengthening public confidence in the Canadian mutual fund industry.

(b) **Foreign Exchange Dealers Association of India (FEDAI):** Foreign Exchange Dealers Association of India (FEDAI) was set up in 1958 as an Association of banks dealing in foreign exchange in India (typically called Authorised Dealers - ADs) as a self-regulatory body and is incorporated under Section 25 of The Companies Act, 1956. Its major activities include framing of rules governing the conduct of inter-bank foreign exchange business among banks vis-à-vis public and liaison with RBI for reforms and development of forex market.

**Internationally**, forex dealers provide online trading services to allow individuals to speculate on rapidly changing foreign exchange rates. Forex Dealer Members (FDMs) are regulated in the United States by the Commodity Futures Trading Commission (CFTC) and National Futures Association (NFA), as well as by national and local regulatory bodies where they conduct business.

(c) **Fixed Income Money Market and Derivative Association of India (FIMMDA)**

The Fixed Income Money Market and Derivatives Association of India (FIMMDA), an association of Scheduled Commercial Banks, Public Financial Institutions, Primary Dealers, and Insurance Companies was incorporated as a Company under section 25 of the Companies Act, 1956 on June 3rd, 1998. FIMMDA is a voluntary market body for the bond, money, and derivatives markets.

FIMMDA has members representing all major institutional segments of the market. The membership includes Nationalized Banks such as State Bank of India, its associate banks and other nationalized banks; Private sector banks such as ICICI Bank, HDFC Bank, IDBI Bank; Foreign Banks such as Bank of America, ABN Amro, Citibank, Financial institutions such as IDFC, EXIM Bank, NABARD, Insurance Companies like Life Insurance Corporation of India (LIC), ICICI Prudential Life Insurance Company, Birla Sun Life Insurance Company and all Primary Dealers.

**The International Swaps and Derivatives Association (ISDA)** is a trade organization of participants in the market for over-the-counter derivatives. Its headquarter is in New York City, and has created a standardized contract (*the ISDA Master Agreement*) to enter into derivatives transactions.

**(d) Association of Investment Bankers of India (AIBI)**

In the early 1990s, the merchant banking industry in India witnessed a phenomenal growth with over 1500 merchant bankers registered with SEBI. To ensure the wellbeing of the industry and for promoting healthy business practices, it became necessary to set up a Self-Regulatory Organization within the industry. This led to the birth of the Association of Investment Bankers of India (AIBI). AIBI was promoted to exercise overall supervision over its members in the matters of compliance with statutory rules and regulations pertaining to merchant banking and other activities. AIBI was granted recognition by SEBI to set up professional standards, for providing efficient services and to establish standard practices in merchant banking and financial services. AIBI, in consultation with SEBI, is working towards improving the compliance of statutory requirement in a systematic manner.

AIBI's primary objective is to ensure that its members render services to all its constituents within an agreed framework of ethical principles and practices. It also works as a trade body promoting the interests of the industry and of its members. (Source [www.aibi.org.in](http://www.aibi.org.in))

**Internationally, International Association of Investment Bankers (IAIB)** since its inception in 1994 has leveraged its collective expertise, best practice knowledge, industry insights, and global reach to assist clients in executing mergers, acquisitions, divestitures, and strategic partnerships.

Its membership is composed of established boutique investment banks from around the world whose primary focus is advising middle market and emerging growth companies. As a highly collaborative group, they hold monthly conference calls and gather twice each year to review creative transaction structures and current market dynamics, as well as to share perspectives

on important industry issues. Through these efforts, they can offer their clients a truly differentiated advisory service that leverages the significant transaction experience and domain expertise of their member firms.

The International Association of Investment Bankers (IAIB) is an affiliation of investment banking firms from Europe, North America, Australia, and Asia, working together to broaden their reach and leverage their expertise within the global marketplace.

Since 1994, the IAIB member firms have utilized this network to offer their clients worldwide access to providers of capital, advisory services and acquirers and sellers of businesses. With this capability, member firms can provide substantial added value to their clients beyond that typically offered by purely domestic advisors.

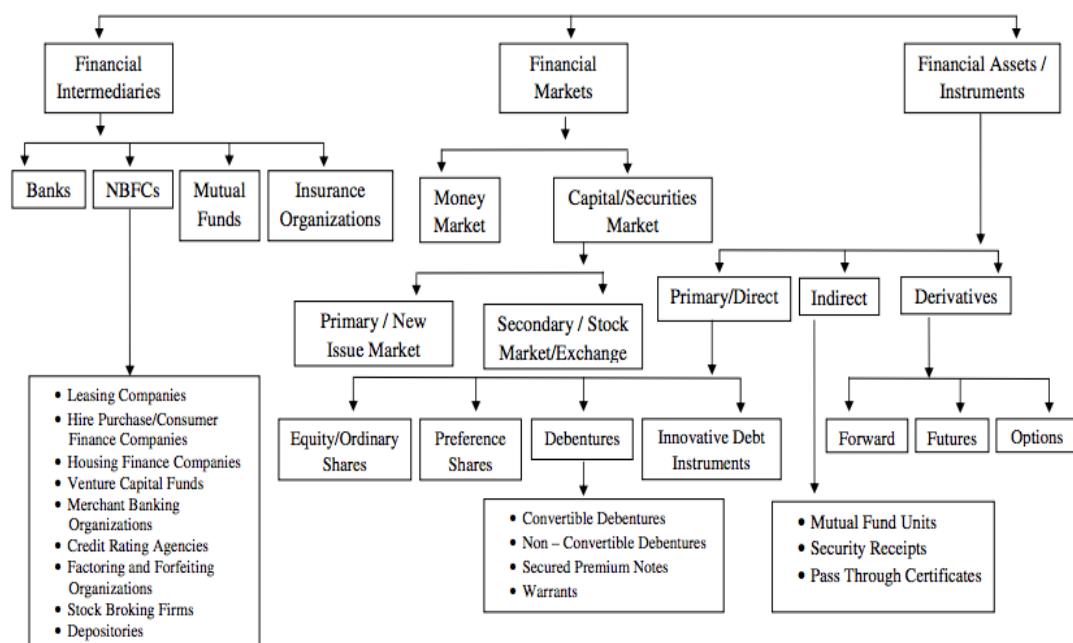
(Source [www.iab.org](http://www.iab.org))



## 4. INDIAN FINANCIAL MARKET SCENARIO

The Indian economy is a developing one and so is the Indian financial market ecosystem. The market is well regulated by SEBI, along with other regulators. The pace of development, in terms of systems and enablers, has been quite fast. Though we are yet to catch up with developed markets like the USA on many parameters, it is because we are still a developing economy.

*Let us look at the components of the Indian financial market:*



Source: Google to <http://practicemock.com/blog/lic-ao/o/insurance-financial-market-awareness-indian-financial-system/>

## 4.1 Money Market Instruments

The money market is the market for financial assets that are close substitutes for money. It is the market for instruments ranging from one day deployment e.g., call money market to a few months, but upto or less than one year.

### 4.1.1 Treasury Bills

Treasury Bills (T-Bills) are short term instruments issued by the Central Government with maturities in less than one year. Their purpose remains the same as Dated Securities (i.e., regular Government Securities), but they are intended more to be meeting the short-term funding needs of the Central Government. Currently, the Central Government issues T Bills of 91-day, 182-day and 364-day maturity. Since T Bills have a maturity of less than one year, they are a money market instrument.

### 4.1.2 Cash Management Bills

These are a short-term instrument issued by the Government of India and meant to specifically meet temporary cash flow mismatches of the Government. These instruments have a maturity of less than 91 days. Further, they are issued at a discount to par value (in zero-coupon securities). CMBs have similar characteristics as Treasury Bills.

### 4.1.3 Call Money, Notice Money, and Term Money

These are the terms used for short-term borrowing and lending operations between Banks and sometimes with and between Primary Dealers. The difference between the three is in their tenure of lending. Call money is for overnight deployment i.e., one day, notice money is two to fourteen days and term money is for a tenure fifteen days and longer.

### 4.1.4 Certificate of Deposits (CDs)

CDs are issued by banks for short-term funding needs. Usually, banks issue CDs when credit pick-up is higher than bank deposit growth. CDs save on operational costs of the Bank as these take place in bulk. Issued for 3, 6 and 12 months maturity. Also, issued at a discount and redeemed at par.

#### 4.1.5 Commercial Papers (CPs)

CPs are issued by corporates (mostly NBFCs), primary dealers and all-India financial institutions (other than Banks), as a source of short-term finance. In a way CDs and CPs are similar, difference being CDs are issued by Banks and CPs are issued by corporates. Issued at a discount to face value and contains higher risk and yield than T-Bills.

#### 4.1.6 Repurchase Agreements

These are short-term loans in which two parties agree to sell and repurchase the same security. When considering a transaction from the seller's point of view, it is called a repo, and when considering it from the buyer's point of view, it is called a reverse repo.

Only transactions in Central Government dated securities, Treasury bills, state development loans, and GOI special securities like oil bonds that have been approved by the RBI may be conducted through Repo or Reverse Repo between parties that have received RBI approval.

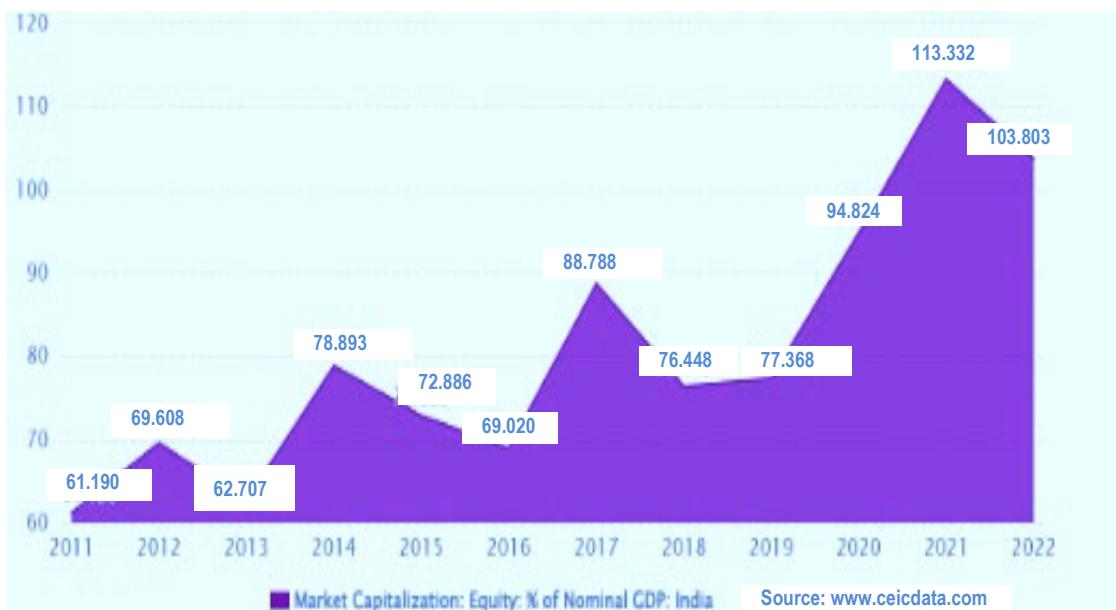
### 4.2 Capital Market

The capital market provides support to corporates for raising resources. The Securities and Exchange Board of India (SEBI), along with the Reserve Bank of India are the regulatory authorities for Indian securities market, to protect investors and improve the microstructure of capital markets in India.

There are two components of capital market, primary and secondary. In primary markets, companies, governments, or public sector institutions can raise funds through bond issues. In the primary market, the investor directly buys shares / bonds of a company. In secondary markets, the shares / bonds are bought and sold by the customers. On the platforms provided by Exchanges like NSE or BSE, investors buy and sell instruments like stocks and bonds through brokers / sub-brokers.

#### 4.2.1 Indian Capital Market scenario (Equity Market)

The market capitalization to Gross Domestic Product (GDP) ratio shows to what extent the market is assigning a value to the listed corporates against the GDP of the economy. The perspective is the current value against the historical average. The stock market capitalization-to-GDP ratio is also known as the Buffett Indicator, after legendary investor Warren Buffett, who popularized its use. This measures the total value of all listed shares divided by GDP.



The chart above shows that investments in, and discounting of future earnings growth of Indian companies has been moving up during the FY 2011 to 2022 represented by the increase in the ratio of market capitalization to GDP.

However, earnings growth of companies has not kept pace with the increase in valuations given by the market, as indicated in the chart above. If EPS does not grow as much and price goes up, the market valuation, as represented by P/E ratio, moves to the higher side.



Source: PhillipCapital India Research

The P/E ratio, calculated on the basis of forward or expected EPS, has moved to the higher side.

## 4.2.2 Historical Returns from Equity

Returns from the equity market have been volatile. The following chart shows returns from Sensex since inception on a rolling basis. Annual rolling means returns of every one year calculated every year, three-year rolling return means returns over past three years, calculated every year, and so on.

Year End (1)	Sensex (2)	Rolling 1 YR Growth (3)	Rolling 3 YR Growth (4)	Rolling 5 YR Growth (5)	Rolling 10 YR Growth (6)	Rolling 15 YR Growth (7)	Rolling 20 YR Growth (8)
Mar-79	100						
Mar-80	129	29%					
Mar-81	173	35%					
Mar-82	218	26%	30%				
Mar-83	212	-3%	18%				
Mar-84	245	16%	12%	20%			
Mar-85	354	44%	18%	22%			
Mar-86	574	62%	39%	27%			
Mar-87	510	-11%	28%	19%			
Mar-88	398	-22%	4%	13%			
Mar-89	714	79%	8%	24%	22%		
Mar-90	781	9%	15%	17%	20%		
Mar-91	1168	50%	43%	15%	21%		
Mar-92	4285	267%	82%	53%	35%		
Mar-93	2281	-47%	43%	42%	27%		
Mar-94	3779	66%	48%	40%	31%	27%	
Mar-95	3261	-14%	-9%	33%	25%	24%	
Mar-96	3367	3%	14%	24%	19%	22%	
Mar-97	3361	0%	-4%	-5%	21%	20%	
Mar-98	3893	16%	6%	11%	26%	21%	

Mar-99	3740	-4%	4%	0%	18%	20%	20%
Mar-00	5001	34%	14%	9%	20%	19%	20%
Mar-01	3604	-28%	-3%	1%	12%	13%	16%
Mar-02	3469	-4%	-2%	1%	-2%	14%	15%
Mar-03	3049	-12%	15%	-5%	3%	15%	14%
Mar-04	5591	83%	16%	8%	4%	15%	17%
Mar-05	6493	16%	23%	5%	7%	15%	16%
Mar-06	11280	74%	55%	26%	13%	16%	16%
Mar-07	13072	16%	33%	30%	15%	8%	18%
Mar-08	15644	20%	34%	39%	15%	14%	20%
Mar-09	9709	-38%	-5%	12%	10%	6%	14%
Mar-10	17528	81%	10%	22%	13%	12%	17%
Mar-11	19445	11%	8%	12%	18%	12%	15%
Mar-12	17404	-10%	21%	6%	18%	12%	7%
Mar-13	18836	8%	2%	4%	20%	11%	11%
Mar-14	22386	19%	5%	18%	15%	13%	9%
Mar-15	27957	25%	17%	10%	16%	12%	11%
Mar-16	25342	-9%	10%	5%	8%	14%	11%
Mar-17	29621	17%	10%	11%	9%	15%	11%
Mar-18	32969	11%	6%	12%	8%	17%	11%
Mar-19	38673	17%	15%	12%	15%	14%	12%
Mar-20	29468	-24%	0%	1%	5%	11%	9%
Probability of Gain		27/41	32/39	34/37	31/32	27/27	22/22

Source: HDFC Mutual Fund

### How to read it?

Return of 29% from March 1979 to March 1980 means over a holding period of one year. Then it goes on like this every year. Return of 30% from March 1979 to March 1982 means over a holding

period of 3 years, annualized. Similarly, the same pattern will be followed for other 3-year holding periods.

### **Conclusion:**

On a one-year holding period basis, returns were positive in 25 out of 38 years, hence the probability of positive return is 25/38. Over 10-year holding periods, it is positive in 28 out of 29 years, hence over a long holding period probability of positive return is 28/29. Over 15 and 20 year holding periods, it is always positive.

### **4.2.3 Bond Market**

The Government and corporates issue bonds / debentures for raising resources. The market capitalization concept is not used in the bond market as the market price is not much different from the face value of instruments. To gauge the size of the market, we will look at the outstanding quantum of securities. The primary goal of the bond market is to provide a mechanism for long term funding of public and private expenditures. The most important advantage of investing in bonds is that it helps diversify and grow your money. Debt or Bond can be defined as a loan for which an investor is the lender. The issuer of the bond pays the investor interest (at a predetermined rate and schedule) in return for the funding. The maturity date refers to the date on which the issuer has to repay the principal to the investor. When an investor invests money via equity, he becomes an owner in the corporation. In case of debt, the investor becomes a creditor to the issuing entity. To build a diversified and stable portfolio, investing in debt securities is a must since it assures fixed income.

	<b>Amount outstanding as on 31 Dec. 2015 (₹ Cr)</b>	<b>% of total Dec. 2015</b>	<b>Amount outstanding as on (₹ Cr)</b>
G Secs	45,19,205	51	1,00,33,518.106 (as on Dec. 4, 2023)
SDLs	14,51,236	16	95,77,920 (as on Oct. 2023)
T Bills	4,25,648	5	1,00,65,404.70 (24 Nov. 2023)
Total Sovereign	63,96,089	72	No added the numbers above as the dates are different
Corporate Bonds	19,11,226	22	44,16,320 (Sept. 2023)
CPs	3,08,109	4	3,64,999.65 (April 30, 2022)
CDs	2,06,559	2	201427.56 (April 22, 2022)

Total Corporate	24,26,294	28	No added the numbers above as the dates are different
Total	88,22,383	100	

Source: RBI, SEBI

As we observe from the chart above, the outstanding quantum of Government Securities, both Centre and States, have been going up steadily. This is in line with the GDP growth of the country and increase in size of Government budgets. The Central Government is the major issuer of securities in the bond market.

Corporate bonds and Commercial Papers have also been increasing steadily, in line with the growth of the corporate sector. This is another means of raising resources for them, apart from Bank loans.

Money market instruments like Treasury Bills and Certificates of Deposit have not increased much as these are means of short-term funding. CPs have increased in quantum as the major issuers are NBFCs; NBFCs require money as that is their input and output.

#### 4.2.4 Subscribers to Government Securities

Table 4.4: Ownership Pattern of Government of India Dated Securities  
(Per Cent of Outstanding Dated Securities)

Category	2016			2017			2018	
	Sep.	Dec.	March	Jun	Sep	Dec	March	June
1. Commercial Banks	40	40.9	40.5	39.7	40.4	41.4	42.7	41.8
2. Non-Bank PDs	0.1	0.3	0.2	0.3	0.3	0.3	0.3	0.3
3. Insurance Companies	22.7	22.5	22.9	23.1	23.5	23.6	23.5	24.2
4. Mutual Funds	2.1	2	1.5	1.4	1.9	1.3	1	1.1
5. Co-operative Banks	2.5	2.6	2.7	2.7	2.6	2.7	2.6	2.6
6. Financial Institutions	0.8	0.9	0.8	0.7	0.8	0.8	0.9	0.9
7. Corporates	1.1	1.1	1.1	1.3	1	1.1	0.9	1.1
8. FPIs	3.8	3.1	3.5	4.3	4.6	4.5	4.4	3.8
9. Provident Funds	6.3	6.2	6.3	6.1	6	5.3	5.9	5.8
10. RBI	14.8	14.6	14.7	14.3	12.8	11.9	11.6	11.6
11. Others	5.8	5.8	6	6.1	6.1	6.9	6.3	6.6
<b>Total</b>	<b>100</b>							

Source: RBI

**TEST YOUR KNOWLEDGE****Multiple Choice Questions (MCQs)**

1. The derivatives market deals in contracts whose value is based on the market value of the asset being traded, called the .....
  - (a) Forwards
  - (b) Futures
  - (c) Options
  - (d) Underlying
2. Which among the following is not a function of Financial Markets?
  - (a) puts savings into more productive use
  - (b) determines the price of securities
  - (c) makes financial assets risky and liquid
  - (d) lowers the cost of transactions
3. Which among the following is the primary stakeholder in the financial market?
  - (a) Merchant Bankers
  - (b) Brokers
  - (c) Underwriters
  - (d) Companies
4. The ..... make their profit on the difference in price between what they paid before the IPO and when the shares are offered to the public.
  - (a) Underwriters
  - (b) Merchant Bankers
  - (c) Brokers
  - (d) Custodians

5. .... is a voluntary market body for the bond, money, and derivatives markets.
- (a) AMFI
  - (b) FIMMDA
  - (c) AIBI
  - (d) FEDAI

### Theoretical Questions

1. What do you understand by financial markets? Discuss the importance of financial markets.
2. Explain briefly the various service providers in financial markets.
3. Discuss the important objectives of SEBI and make a brief comparison to its compatriot in USA.
4. Explain briefly the various administrative authorities to facilitate the financial market.

## ANSWERS/SOLUTIONS

### Answers to the MCQ based Questions

1.	(d)	2.	(c)	3.	(d)	4.	(a)	5.	(b)
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### Answers to the Theoretical Questions

1. Please refer to paragraph 1.2
2. Please refer to paragraph 3
3. Please refer to paragraph 3.(iii)
4. Please refer to paragraph 3.(iv)