CHAPTER II

INTRODUCTION TO FINANCIAL MARKETS
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I. INTRODUCTION:

A significant component of the Indian Financial System is the financial markets. They function as facilitating organisations in the savings-investment process. The Financial markets are in the forefront in developing economics. Efficient financial markets are a sine qua non for speedy economic development. The vibrant financial market enhances the efficiency of capital formation. This market facilitates the flow of savings into investment vis-a-vis capital formation. Dr. Khan has opined that, "A variegated financial market can appeal to the security, motivation and other such aspects of savers and attracts more savings by the creation of an array of attractive financial assets. It also tends to promote the development financial structure. The role of the financial markets in the financial system is quite unique. The relevance of the financial markets in the financial system is not merely quantitative but also supportive. Thus, the financial markets bridge one set of financial intermediaries with another set of players. Well-developed financial markets diversify resource mobilisation channels and enlarge the range of financial services. More importantly, under appropriate conditions financial markets can provide long-term finance to government and large business firms. The role of financial markets assumes greater importance in the modern economy. Financial markets perform an important function of channellising surplus funds from savers to those who are short of funds, thereby contributing to higher production and efficiency in the economy. In the wake of increased degree of globalisation, financial markets facilitate across border movements of funds from the countries tacking profitable avenues for investments to
countries providing higher returns. Another crucial role of financial market is the pricing and management of economic and financial risks. Financial markets also play a crucial role in the transmission of monetary policy, impulses developed and stable financial markets also enable central banks to use market-based instruments of monetary policy to target monetary variables more effectively. Thus, the financial markets through their linkages with the real economy, enhance the levels of output and employment. They act as a conduit through which funds are transferred from the savers to users. Financial markets facilitate the buying and selling of financial instruments, also called financial assets or financial securities. Efficient Financial Markets indicate the economy's ability to take advantage of profitable opportunities. Financial markets in fact reflect the risk perceptions and reward of millions of individual investors from pension funds, banks, hedge funds and healthy individuals to businessmen wanting to raise money borrowers of home loans and pensioners looking for ways to invest in their nest eggs. To a large extent Financial markets hold up a mirror to the economy. The equilibrium in financial markets is usually determined by assuming that there would be perfect competition, and by using the well-known tool of supply and demand. Financial markets are said to be perfect when:

(a) a large number of savers and investors operate in markets
(b) the savers and investors are rational
(c) all operators in the market are well-informed and information is freely available to all of them
(d) there are no transaction costs
(e) the financial assets are infinitely divisible
(f) the participants in markets have homogeneous expectations, and
(g) there are no taxes
II. CHARACTERISTICS OF FINANCIAL MARKETS:

There are various characteristics of Financial Markets which may be summed up as follows:

(i) Financial Markets are characterised by a large volume of transactions and the speed with which financial resources move from one market to another.

(ii) There are various segments of Financial Markets such as stock markets, bond markets, primary and secondary segments, wherever themselves decide when and where they should invest money.

(iii) There is scope for instant arbitrage among various markets and types of instruments.

(iv) Financial Markets are highly volatile and susceptible to panic and distress selling as the behaviour of a limited group of operators can get generalised.

(v) Markets are dominated by financial intermediaries who take investment decision as well as risks on behalf of their depositors.

(vi) Negative externalities are associated with financial markets. A failure in any one segment of these markets may affect other segments, including non-financial markets.

(vii) Domestic financial markets are getting integrated with worldwide financial markets. The failure and vulnerability in a particular domestic market can have international ramification. Similarly problems in external markets can affect the functioning of domestic markets. In view of the above characteristics, financial markets need to be closely monitored and supervised.
III. FUNCTIONS OF FINANCIAL MARKETS:

The primary function of the Financial Markets is to facilitate the transfer of funds from surplus sectors (lenders) to deficit sectors (borrower). Financial Markets perform the essential economic function of channeling funds from households, firms and governments that have saved surplus funds by spending less than their income to those that have a shortage of funds because they wish to spend more than their income. Financial markets perform various functions such as:

(a) Enabling economic units to exercise their time preference,
(b) Separation, distribution, diversification and reduction of risk,
(c) Efficient payment mechanism
(d) Providing information about companies which spurs investors to make inquiries themselves and keep track of the companies activities with a view to trading in their stock efficiently.
(e) Transmutation or transformation of financial claims to suit the preferences of both savers and borrowers.
(f) Enhancing liquidity of financial claims through trading in securities and
(g) Providing portfolio management services.

IV. CLASSIFICATION OF FINANCIAL MARKETS:

There are various classifications of Financial Markets in the economy as according to the instruments being traced in those markets and also according to the people working and the period of the instruments being traded in those Financial Markets. The Financial Market may be classified as Government Securities market and Corporate Securities market. The Government securities market in India has two segments i.e. the primary
market and secondary market. The primary market consists of the issuers of securities, the central and state government, while the buyers include commercial banks, primary dealers, financial institutions and insurance companies. The secondary market includes commercial banks, financial institutions, insurance companies, provident funds, trusts, mutual funds and the Reserve Bank of India. On the basis of the type of instruments traded the financial market for corporate securities may be classified as capital market and money market. The capital market is a market for long-term funds and the securities traded in the capital market are equity shares, preference shares, debentures and bonds. The capital market is further divided into primary and secondary markets. The primary market provides funds to the enterprises for starting new organisation or for their expansion/diversification. The secondary market is a market for existing securities. It is also known as stock market or stock exchange, and provides an institutional mechanism for the purchase and sale of securities that have already been issued. If the securities traded in a financial market are short-term securities, such a financial market is known as money market. A debt market is a financial market for debt securities such as debentures, bonds and commercial paper. The Financial Market that provides a mechanism or a system for trading long term securities such as equity shares which have been already issued is called the stock market. The Financial Markets may also be classified as organised market and unorganised (informal) markets. The organised markets are the market governed by certain explicit rules, regulations and statutes. The unorganised markets are those that are not governed by prescribed rules and regulations.

V. MONEY MARKET

Introduction:

Money market is a very important segment of the Indian Financial System. It is the market for dealing in monetary assets of a short-term nature.
Short term funds up to one year and for financial assets that are close substitutes for money are dealt in the money market. Money market instruments have the characteristics of liquidity (quick conversion into money), minimum transaction cost and no loss in value. Money market performs the crucial role of providing an equilibrating mechanism to even out short-term liquidity and in the process, facilitate the conduct of monetary policy short-term surpluses and deficits are evened out. The Money Market is the major mechanism through which the Reserve Bank influences liquidity and the general level of rates of interest. The money market is a market for financial assets that are close substitutes for money. It is a market for instruments having a maturity period of one or less than one year. It is a market for overnight to short-term funds and for short-term money and financial assets that are close substitutes for money. "Short-term" in the Indian context, generally means a period up to one year and “close substitute for money” denotes any financial asset that can be quickly converted into money with minimum transaction cost and without any loss in value. The major participants in the market are the commercial banks, the other financial intermediaries, large corporates and the Reserve Bank of India (RBI).

**Need of the money market:**

The existence of an efficient money market is a precondition for the development of a government securities market and a forward, swaps and futures is also supported by a liquid money market as the certainty of prompt cash settlement is essential for such transactions. The government can achieve better pricing on its debt as it provides access to a wide range of buyers. The need for money market arises because the immediate cash needs of individuals, corporations and governments do not necessarily coincide with their receipts of cash. In general, a money market, provides an investment opportunity that generates a higher rate of interest than holding cash, but it is also very liquid and has relatively low default risk.
Features of money market:

The developed money markets bear certain distinct features as compared to other market which may be summed up as follows:

(i) **A developed commercial banking system:** In a developed money market not only the banking system should be well developed and organised but the public should also have banking habits. These two things are complementary. The commercial banks are the most important suppliers of short-term funds and their policy pertaining to loans, advances and investment would have its impact and investment would have its impact on the entire money market. S.N. Sen in his book 'Central Banking in Underdeveloped Money Market' rightly calls them "the nucleolus of the whole money market". Thus for any developed money market, the foremost feature is well coordinated and well integrated commercial banking system.

(ii) **Presence of a central bank:** In a developed money market there is always an apex Central Bank. It means the Central Bank is both de jure and de facto the head of money and banking authority. A Central Bank is the lender of the last resort which means that the member banks can borrow from the Central Bank during emergency and due to this reason the Central Bank is also termed as the guardian of the money market. According to Prof. Sen, "It provides the ultimate liquidity without which a money market cannot function efficiently." It is correctly stated that a strong Central Bank is as necessary a characteristic of the money market as the heart in the human body.

(iii) **Sub-markets:** A developed money market has the most developed and sensitive sub-market. The money market is a group of various sub-markets each dealing in loans of various maturities. There will be markets for call loans, the collateral loans, acceptances, foreign
exchange, bills of exchange and treasury bills. If these sub-markets are non-existent or there is less responsiveness to small changes in the interest and discount rates, it means that under no circumstances a money market may be developed. There must be a large number of dealers and bidders in different sub-markets. According to Prof. S.V. Sen, "The larger the number of submarkets, the broader and more developed will be the structure of the money market." But besides it, the sub-markets must be integrated with each other.

(iv) **Near money-assets**: In a developed money market, there is a large quantity and variety of financial instruments such as bills of exchange, treasury bills, promissory notes, short dated government bonds etc. If the numbers of near money assets are more, the money market will be more developed.

(v) **Availability of ample resources**: Another feature of the developed money market is the availability of ample resources. A developed money market has easy access to financial resources from both within and without the country. It is the availability of cheap facilities for the remittance of funds from one place to another, which has resulted in raising the resources.

(vi) **Integrated interest rate structure**: Another feature of developed money market is that it has an integrated interested rate structure. The interest rates which prevail in the different sub-markets must be integrated interest rate structure. The interest rates which prevail in the different sub-markets must be integrated with each other. It is due to this structure of interest rates that the Central Bank can exercise control on the functioning of the money market.

(vii) **Other factors**: There are many other factors which are responsible for the development of a money market. The contributory factors are
volume of international trade, bills of exchange, great industrial
development, stable political condition, economic crisis, boom,
depression, war, absence of discrimination etc.

Thus the aforesaid are the various distinct features that are beared by a
developed money market as compared to the other markets and any features
stated above if are found missing indicates a less developed money market.
An under developed money market is a stumbling block in the way of
monetary authority and also a block in the efficient development of the
Financial System of the country.

Definition of money market:

J.M. Culberston, in his book "Money and Banking", has defined money
market as "a network of markets that are grouped together because they deal in
financial instruments that have a similar function in the economy and are to
some degree substitutes from the point of view of holders. The instruments of
the money market are liquid assets; interest bearing debts that mature within a
short period of time or callable on demand." Geoffrey Crowther in his book "An
outline of Money", has stated "Money Market is a collective name given to the
various forms and institutions that deal with the various grades of near money."

The money market, in a nutshell, is a short term credit market. It deals
in assets of relative liquidity such as treasury bills, bills of exchange, short
term government securities, etc.. The Reserve Bank of India 'Functions and
Working' describes money market as 'the centre for dealings, mainly short
term character, in monetary assets; it meets the short term requirements of
borrowers and provides liquidity or cash to the lenders. It is the place where
short term surplus investible funds at the disposal of financial and other
institutions and individuals are bid by borrowers, again compromising
institutions and individuals and also government itself."
S.N. Sen, in his book "Central Banking in underdeveloped Money Market", has aptly stated that the short term money market is "the place where the strain on the banking system is first felt in periods of pressure, and it is the place where ease in the banking system is first felt in periods of monetary superfluity." The money market is thus a reservoir of short term funds. It is a region where short term fund are bought and sold through telephone or mail. Funds are borrowed in the market for a short period ranging from a day to six months or less than one year. The assets which are used as credit instruments are known as "near money assets".

**Structure of the money market:**

The structure of Money Market can be illustrated as below:

![Money Market Diagram](image)

1. **Components or sub markets of money market:** The money market is not homogeneous in character. This is a loosely organised institution with a number of divisions and sub-divisions. Each particular division or sub-division deals with a particular type of credit operation. All the sub-markets deal in short-term credit. The following are the important constituents or sectors of money market.

   (a) Call Money Market
   
   (b) Collateral Loan Market
   
   (c) Acceptance Market
   
   (d) Bill market
(a) **Call money market:** It refers to the market for very short period. Bill brokers and dealers in Stock Exchange usually borrow money at call from the commercial banks. These loans are given for a very short period not exceeding seven days under any circumstances, but more often from day-to-day or for overnight only i.e. 24 hours. Call loan is an important constituent of the Money Market.

(b) **Collateral loan market:** It is another specialised sector of the Money market. The loans are generally advanced by the commercial banks to private parties in the market. The collateral loans are backed by the securities, stocks and bonds. The collateral securities may be in the form of some valuable, say government bonds which are easily marketable and do not fluctuate much in prices.

(c) **Acceptance market:** Acceptance market refers to the market for banker's acceptances involved in trade transactions. The market where the bankers acceptances are easily sold and discounted is known as the acceptance market.

(d) **Bill market:** It is a market in which short term papers or bills are bought and sold. The important types of short-term papers are:

(i) Bills of Exchange
(ii) Treasury Bills

2. **Institutions of money market:** The institutions of money markets are those which deal in lending and borrowing of short term funds. The Central Bank, Commercial Banks, Acceptance Houses, Non-Banking Financial Intermediaries, Brokers, etc. are the major institutions of money markets.
a) **Central bank:** The Central Bank plays a vital role in the money market. It is the monetary authority and is regarded as an apex institution. The Central Bank is the controller and the guardian of the money market.

b) **Commercial banks:** These are the back bone of the Money Market and are one of the major constituents. These banks use their short term deposits for financing trade and commerce for short periods.

c) **Acceptance houses:** The acceptance houses and the bill brokers are the main institutions dealing in the bill market. They function as intermediaries between importers and exporters, and between lenders and borrowers in the short period.

d) **Non-banking financial intermediaries:** In addition to commercial Banks, there are non-banking financial intermediaries which resort to lending and borrowing of short-term funds in the money market.

e) **Bill brokers:** Bill brokers are the intermediaries who act as intermediaries between the borrowers and lenders by discounting bills of exchange at a small rate of commission. These are more active in an under developed money market.

3. **Instruments of the money market:** The following are the major instruments that are available in the Money Market.

   (a) **Commercial bills:** Commercial Bills or Bills of Exchange popularly known as bill is a written instrument containing an unconditional order. The bill is signed by the drawers, directing a certain person to pay a certain sum of money only to, or order of a certain person, or to the bearer of the instrument at a fixed time in future or on demand. Once the buyer signifies his acceptance on the bill itself it becomes a legal document.
(b) **Treasury bills:** The Treasury Bill on the other hand, is the short-term government security, usually of the duration of 91 days, sold by the Central Bank on behalf of the government. There is no fixed rate of interest payable on the T-bills. These are sold by the Central Bank on the basis of competitive bidding.

(c) **Call and short notice money:** Call Money refers to a money given for a very short-period. It may be taken for a day or overnight but not exceeding seven days in any circumstances. Surplus funds of the commercial banks and other institutions are usually given as call money.

(d) **Certificate of deposits:** These are marketable receipts in bearer or registered form of funds deposited in a Bank for a specified period and at a specified rate of interest.

(e) **Commercial papers:** These are short-term usance promissory notes issued by reputed companies with good credit standing and having sufficient tangible assets. These are unsecured and are negotiable by endorsement and delivery.

(f) **Repurchase agreement (REPO):** It is an important instrument in the developed money markets. It enables smooth adjustment of short-term liquidity among varied categories of market participants. It is much safer than call money market operations as it is backed by collaterals.

(g) **ADR's & GDR's:** American Depository Receipts (ADR's) are the fore runners of Global Depositing Receipts (GDRs). These are the instruments in the nature of depository receipt or certificate. These instruments are negotiable and represent publicly traded, local currency equity shares issued by non-American company.
(h) Collateralised borrowing and lending obligation (CBLO): The Clearing Corporation of India Limited (CCIL) launched a new product—Collateralised Borrowing and Lending Obligation (CBLO) in 2003 to provide liquidity to non-bank entities hit by restrictions on access to the call money market.

Significance/functions of money market:

The importance or the functions of money market may be explained as below:

(a) Economic development: The money market provides short-term funds to both public and private institutions who are in need of money to finance their capital needs.

(b) Profitable investment: The aim of the commercial banks to put their reserves into productive channels is to maximise profits. The excess reserves of the Banks are invested in near money assets.

(c) Borrowings by the government: The money market helps the government in borrowing short-term funds at very low interest rates.

(d) Importance for central bank: If the money market is well-developed, the Central Bank implements the monetary policy successfully. It is only through the money market that the Central bank can control the banking system and thus contribute to the development of trade and commerce.

(e) Mobilisation of funds: The money market helps in transferring funds from one sector to another.

(f) Self Sufficiency of commercial banks: In case of the prevalence of a developed money market the commercial banks need not borrow from the Central Bank.
(g) **Savings and investment**: Another point of importance of the money market is that it helps in promoting liquidity and safety of financial assets. By doing so it can help in encouraging saving and investment which ultimately helps in equitable allocation of resources.

**VI. THE INDIAN MONEY MARKET:**

The money market in India is divided into the formal (organised) and informal (unorganised) segments. One of the greatest achievements of the Indian financial system over the last 50 years has been the decline in the relative importance of the informal segment and increasing presence and influence of the formal segment. Upto the mid-1980, money market was characterised by lack of depth, small number of instruments and strict regulation on interest rates. The money market consisted of the inter-bank call market, treasury bills, commercial bills and participation certificates. Several steps were taken in the 1980s and 1990s to reform and develop the money market. The reforms in the money market were initiated in the latter half of the 1980s. A committee to review the working of the monetary system under the chairmanship of Sukhamoy Chakravorty was set up in 1985. It underlined the need to develop money market instruments. As a follow-up, the Reserve Bank set-up a working group on the money market under the chairmanship of N. Vaghul which submitted its report in 1987. This committee laid the blue print for the institution of a money market. Based on its recommendations, the Reserve Bank initiated a number of measures. The Government again set-up a high level committee in August 1991 under the Chairmanship of M. Narasimhan (the Narsimhan Committee) to examine all aspects relating to structure, organisation, functions, and procedures of the financial system. The committee made several recommendations for the development of the money market. The Reserve Bank accepted many of its
recommendations. The development and profile of the money market has changed in the nineties. A basic objective of money market reforms in the recent years has been to facilitate the introduction of new instruments and their appropriate pricing. The Reserve Bank has endeavoured to develop market segments which exclusively deal in specific assets and liabilities as well as participants. Accordingly the call/notice money market is now a pure inter-bank market. In order to ensure systematic stability, prudential limits on exposures to the call money market have been imposed. Standing liquidity support to Banks from the Reserve Bank and facilities for exceptional liquidity support have been rationalised. The various segments of the money market have integrated with the introduction and successful implementation of the Liquid Adjustment Facility (LAF) in June, 2000. The Negotiated Dealing System (NDS) & Clearing Corporation of India Ltd. (CCIL) have improved the functioning of money markets. They have facilitated a speedier conversion of notice/call money market into a pure inter-bank money market and enabled the growth of a buoyant repo market outside the LAF.

VII. CAPITAL MARKET

Introduction:

A good-capital market is an essential pre-requisite for industrial and commercial development of a country. Credit is generally required and supplied on short-term and long-term basis. The money-market caters to the short-term needs only. The long-term capital needs are met by the capital market. Capital market is a central coordinating and directing mechanism for free and balanced flow of financial resources into the economic system operating in a country. The development of a good capital market in a country is dependent upon the availability of savings, proper organisation of its constituent units and the entrepreneurship qualities of its people.
Meaning and concept:

The term capital market refers to the institutional arrangements for facilitating the borrowing and lending of long-term funds. In the widest sense it consists of a series of channels through which the savings of the community are made available for industrial and commercial enterprises and public authorities. A Capital Market may be defined as an organised mechanism for effective and efficient transfer of money capital or financial resources from the investing parties, i.e. individuals or institutional savers to the entrepreneurs (individuals or institutions) engaged in industry or commerce in the business either be in the private or public sectors of an economy. It is the market for financial assets that have long or indefinite maturity. It is basically composed of those who demand funds (borrowers) and those who supply funds (lenders).

Definition of capital market:

It is an organised market mechanism for effective and efficient transfer of money capital or financial resources from the investing class (a body of individual or institutional savers) to the entrepreneur class (individual or institutions engaged in industry business or service) in the private and public sectors of the economy. In a very broad sense, it includes the market for short-term funds. H.T. Parikh has referred to it as, "By Capital Market, I mean the market for all the financial instruments, short-term and long-term as also commercial, industrial and government paper."

In the words of Goldsmith, "the capital market of a modern economy has two basic functions: first the allocation of savings among users and investment; second the facilitation of the transfer of existing assets, tangible and intangible among individual economic units." Grant defines capital market in abroad sense as "a series of channels through which the savings of
the community are made available for industrial and commercial enterprises and for public authorities. It embraces not only the system by which the public takes up long-term securities directly or through intermediaries but also the elaborate network of institutions responsible for short-term and medium-term lending." From the above definitions, it may be deducted that the capital market is generally understood as the market for long-term funds. The capital market provides long-term debt and equity finance for the government and the corporate sector. By making long term investments liquid, the capital market mediates between the conflicting maturity preference of lenders and borrowers. The capital market also facilitates the dispersion of business ownership and the reallocation of financial resources among corporations and industries.

**Role and functions of capital market:**

The Capital Market plays a vital role in providing liquidity and investment instruments. It fosters economic growth in various ways such as by augmenting the quantum of savings and capital formation and through efficient allocation of capital, which, in turn, raises the productivity of investment. It also enhances the efficiency of a financial system diverse competitors vie with each other for financial resources. The domestic capital market can help financial stability by reducing currency mismatches. The capital market also provides an alternative means of long-term resources for development. It improves economic efficiency by generating market determined interest rates that reflect the opportunity costs of funds at different maturities.

Capital Market performs various important functions in the Financial System of any country. The various functions of an efficient capital market may be summed up as follows:

(i) Mobilise long-term savings to finance long-term investments.
(ii) Provide risk capital in the form of equity or quasi-equity to entrepreneurs.

(iii) Encourage broader ownership of productive assets.

(iv) Provide liquidity with a mechanism enabling the investor to sell financial assets.

(v) Lower the costs of transactions and information.

(vi) Improve the efficiency of capital allocation through a competitive pricing mechanism.

(vii) Disseminate information efficiently for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment, or holding a particular financial asset.

(viii) Enable quick valuation of financial instruments — both equity and debt.

(ix) Provide insurance against market risk or price risk through derivative trading and default risk through investment protection fund.

(x) Enable wider participation by enhancing the width of the market by encouraging participation through, networking institutions and associating individuals.

(xi) Provide operational efficiency through simplified transaction procedures, lowering settlement timings and lowering transaction costs.

(xii) Develop integration among real and financial sectors, equity and debt instruments, long-term and short-term funds, long-term and short-term interest costs, private and government sectors and domestic and external funds.
(xiii) Direct the flow of funds into efficient channels through investment, disinvestment and re-investment.

**Objectives and importance of capital market:**

An efficient Capital Market is a pre-requisite of economic development. An organised and well developed Capital Market operating in a free market economy, (i) ensures best possible coordination and balance between the flow of savings on the one hand and the flow of investment leading to capital formation on the other; (ii) directs the flow of savings into most profitable channels and thereby ensures optimum utilisation of financial resources. Thus, an ideal capital market is one where finance is used as a hand-maid to serve the needs of industry. The importance of capital market can be briefly summarised as follows:

(i) The Capital Market serves as an important source for the productive use of the economy's savings. It mobilises the savings of the people for further investment and thus avoids their wastage in unproductive uses.

(ii) It provides incentives to savings and facilitates capital formation by offering suitable rates of interest as the price of capital.

(iii) It provides an avenue for investors, particularly the household sector to invest in financial assets, which are more productive than physical assets.

(iv) It facilitates increase in production and productivity in the economy and thus, enhances the economic welfare of the society. Thus it facilitates "the movement of stream of command over capital to the point of highest yield" towards those who can apply them productively and profitably to enhance the national income in the aggregate.
(v) The operations of different institutions in the Capital Market induce economic growth. They give quantitative and qualitative directions of the flow of funds and bring about rational allocation of scarce resources.

(vi) A healthy capital market consisting of expert intermediaries promotes stability in values of securities representing capital funds.

(vii) Moreover, it serves as an important source for technological upgradation in the industrial sector by utilising the funds invested by the public.

**Structure of capital market:**

The structure of any capital market is composed of the sources of demand for and supply of long-term capital. In the organised sector of capital market demand for long-term capital comes from corporate enterprises, public sector enterprises, government and semi-government institutions. The sources of supply of funds comprise individual investors, corporate and institutional investors, investment intermediaries, financial institutions, commercial banks and government. The unorganised sector of the Capital Market consists of indigenous bankers and private money lenders.

**Components of capital market:**

The Capital Market basically comprises of the Primary Capital Market and the Secondary Capital Market. The Capital Market may also defined as comprising of the New Issue Market or Primary Market, Stock Market or Secondary Market and also the Financial Institutions. Primary Market refers to the long-term flow of funds from the surplus sector to the government and corporate sector (through primary issues) and to banks and non-banking financial intermediaries (through secondary issues).
Secondary Capital Market is a market for outstanding securities. An equity instrument, being an eternal fund provides an all time market while a debt instrument with a defined maturity period, is traded at the secondary market till maturity. Unlike primary issues in the primary market which result in capital formation, the secondary market facilitates only liquidity and marketability of outstanding debt and equity instruments. Thus the constituents of the Capital Market comprises of development banks, specialised financial institutions, investment institutions, state level development banks, mutual funds, lease companies, financial service companies, commercial banks and other specialised institutions setup by Development Banks for the growth of Capital Market.

VIII. HISTORY OF THE INDIAN CAPITAL MARKET

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

Trading was at that time limited to a dozen brokers; their trading place was under a banyan tree in front of the Town Hall in Bombay. These stock brokers organised an informal association in 1875 – the Native Shares and Stock Brokers Association, Bombay. The stock exchanges in Calcutta and Ahmedabad, also industrial and trading centres, materialised later. The
Bombay Stock Exchange was recognised in May 1927 under the Bombay Securities Contracts Control Act, 1925.

The capital market was not well-organised and developed during the British rule because the British government was not interested in the economic growth of the country. As a result, many foreign companies depended on the London capital market for funds rather than on the Indian capital market.

In the post-independence era also, the size of the capital market remained small. During the first and second five year plans, the government's emphasis was on the development of the agricultural sector and public sector undertakings. Public sector undertakings were healthier than private undertakings in terms of paid-up capital but their shares were not listed on the stock exchanges. Moreover, the Controller of Capital Issues (CCI) closely supervised and controlled the timing, composition, interest rates, pricing, allotment, and floatation costs of new issues. These strict regulations demotivated many companies from going public for almost four and a half decades.

In the 1950s, Century Textiles, Tata Steel, Bombay Dyeing, National Rayon, and Kohinoor Mills were the favourite scrips of speculators. As speculation became rampant, the stock market came to be known as the satta bazaar. Despite speculation, non-payment or defaults were not very frequent. The government enacted the Securities Contracts (Regulation) Act in 1956 to regulate stock markets. The Companies Act, 1956 was also enacted. The decade of the 1950s was also characterised by the establishment of a network for the development of financial institutions and state financial corporations.

The 1960s was characterised by wars and droughts in the country which led to bearish trends. These trends were aggravated by the ban in 1969
on forward trading and badla, technically called 'contracts for clearing'. Badla provided a mechanism for carrying forward positions as well as for borrowing hinds. Financial institutions such as LIC and G1C helped revive the sentiment by emerging as the most important group of investors. The first mutual hind of India, the Unit Trust of India (UTI) came into existence in 1964.

In the 1970s, badla trading was resumed under the guise of 'hand-delivery contracts – a group.' This revived the market. However, the capital market received another severe setback on July 6, 1974, when the government promulgated the Dividend Restriction Ordinance, restricting the payment of dividend by companies to 12 per cent of the face value or one-third of the profits of the companies that can be distributed as computed under Section 369 of the Companies Act, whichever was lower. This led to a slump in market capitalisation at the BSE by about 20 per cent overnight and the stock market did not open for nearly a fortnight. Later came a buoyancy in the stock markets when the multinational companies (MNCs) were forced to dilute their majority stocks in their Indian ventures in favour of the Indian public under FERA in 1973. Several MNCs opted out of India. One hundred and twenty-three MNCs offered shares worth Rs. 150 crore, creating 1.8 million shareholders within four years. The offer prices of FERA shares were lower than their intrinsic worth. Hence, for the first time FERA dilution created an equity cult in India. It was the spate of FERA issues that gave a real fillip to the Indian stock market. For the first time, many investors got an opportunity to invest in the stocks of such MNCs as Colgate, and Hindustan Lever Limited. Then, in 1977, a little-known entrepreneur, Dhirubhai Ambani, tapped the capital market. The scrip, Reliance Textiles, is still a hot favourite and dominates trading at all stock exchanges.

The 1980s witnessed an explosive growth of the securities market in India, with millions of investors suddenly discovering lucrative opportunities.
Many investors jumped into the stock markets for the first time. The government's liberalisation process initiated during the mid-1980s, spurred this growth. Participation by small investors, speculation, defaults, ban on badla, and resumption of badla continued. Convertible debentures emerged as a popular instrument of resource mobilisation in the primary market. The introduction of public sector bonds and the successful mega issues of Reliance Petrochemicals and Larsen and Toubro gave a new lease of life to the primary market. This, in turn, enlarged volumes in the secondary market. The decade of the 1980s was characterised by an increase in the number of stock exchanges, listed companies, paid-up capital, and market capitalisation.

The 1990s will go down as the most important decade in the history of the capital market of India. Liberalisation and globalisation were the new terms coined and marketed during this decade. The Capital Issues (Control) Act, 1947 was repealed in May 1992. The decade was characterised by a new industrial policy, emergence of the SEBI as a regulator of the capital market, advent of foreign institutional investors, euro-issues, free pricing, new trading practices, new stock exchanges, entry of new players such as private sector mutual funds and private sector banks, and primary market boom and bust.

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

The 1991-92 securities scam revealed the inadequacies of and inefficiencies in the financial system. It was the scam which prompted a
reform of the equity market. The Indian stock market witnessed a sea change in terms of technology and market prices. Technology brought radical changes in the trading mechanism. The Bombay Stock Exchange was subject to nationwide competition by two new stock exchanges—the National Stock Exchange, set up in 1994, and the Over the Counter Exchange of India, set up in 1992. The National Securities Clearing Corporation (NSCC) and the National Securities Depository Limited (NSDL) were set up in April 1995 and November 1996 respectively for improved clearing and settlement and dematerialised trading. The Securities Contracts (Regulation) Act, 1956 was amended in 1995-96 for introduction of options trading. Moreover, rolling settlement was introduced in January 1998 for the dematerialised segment of all companies. With automation and geographical spread, stock market participation increased.

In the late-1990s, Information Technology (IT) scrips dominated the Indian bourses. These scrips included Infosys, Wipro, and Satyam. They were a part of the favourite scrips of the period, also known as 'new economy' scrips, along with telecommunications and media scrips. The new economy companies were knowledge intensive unlike the old economy companies that were asset intensive.

The Indian capital market entered the twenty-first century with the Ketan Parekh scam. As a result of this scam, badla was discontinued from July 2001 and rolling settlement was introduced in all scrips. Trading of futures commenced from June 2000, and Internet trading was permitted in February 2000. On July 2, 2001, the Unit Trust of India announced suspension of the sale and repurchase of its flagship US-64 scheme due to heavy redemption leading to a panic on the bourses. The government's decision to privatise oil PSUs in 2003 fueled stock prices. One big divestment of international telephony major VSNL took place in early February 2002.
Foreign institutional investors have emerged as major players on the Indian houses. NSF has an upper hand over its rival BSL in tennis of volumes not only in the equity markets but also in the derivatives market.

It has been a long journey for the Indian capital market. Now the capital market is organised, fairly integrated, mature, more global and modernised. The Indian equity market is one of the best in the world in terms of technology. Advances in computer and communications technology, coming together on Internet are shattering geographic boundaries and enlarging the investor class. Internet trading has become a global phenomenon. Indian stock markets are now getting integrated with global markets.

IX. CAPITAL MARKET INTERMEDIARIES:

A number of agencies called intermediaries play a critical role in the process of issue of new securities. The major intermediaries of the capital securities market include.

1. Merchant bankers/Lead managers
2. Underwriters
3. Bankers to an issue
4. Registrars to an issue
5. Share transfer agents
6. Debenture trustees
7. Portfolio managers

Merchant bankers/lead managers:

Merchant banker is an institution or an organisation which provides a number of services including management of securities issues, portfolio
management services, underwriting of capital issues, insurance, credit syndication, financial advices and project counselling etc. They mainly offer financial services for a fee. They are also different from the dealers, traders and brokers of securities. It has become mandatory now that all public issues should be managed by merchant banker(s) acting as the lead manager(s).

Underwriters:

Underwriting is an act of undertaking the guarantee by an underwriter of buying the shares or debentures placed before the public in the event of non-subscription. Underwriting in the context of a company means undertaking a responsibility or giving a guarantee that the securities (shares and debentures) offered to the public will be subscribed for. The firms which undertake the guarantee are called 'underwriters'. Underwriting is similar to insurance in the sense that it provides protection to the issuing company against the failure of an issue of capital to the public.

Bankers to an issue:

Bankers to an issue is an important intermediary who accepts applications and application monies, collects all monies, refund application monies after allotment and participates in the payment of dividends by companies. They are subject to the rules and regulations framed by SEBI in their regard.

Registrar to an issue and share transfer agent:

The Registrar to an issue is an intermediary who performs the functions

(i) Collecting applications from investors

(ii) Keeping a record of applications

(iii) Keeping record of money received from investors or paid to sellers of shares
(iv) Assisting the companies in the determination of basis of allotment of shares

(v) Helping in despatch of allotment letter refund orders, share certificates etc.

The Share Transfer Agents on the other hand maintain the record of holders of securities or on behalf of the companies and deal with all activities connected with the transfer/redemption of its securities. These are under the control of SEBI and follow the rules made their under.

**Debenture trustees:**

The Regulations define a debenture trustee as a trustee of a trust deed for securing any issue of debentures of a body corporate. Trust deed means a deed executed by the company in favour of trustees named therein for the benefit of the debenture holders.

**Brokers to an issue:**

Brokers are the person who procure subscriptions to issue from prospective investors spread over larger area. A company can appoint as many number of brokers as it wants.

**Portfolio managers:**

The SEBI Regulations define portfolio manager as any person who pursuant to a contract or arrangement with a client, advises or directs or undertakes on behalf of the client, the management or administration of a portfolio of securities or the funds of the client.

**X. DEPOSITORY SYSTEM AND DEMATERIALIZATION:**

It is a system whereby the transfer and settlement of scrips take place not through the traditional method of transfer deeds and physical delivery of scrips but through the modern system of effecting transfer of ownership of
securities by means of book entry on the ledgers or the depository without the physical movement of scrips. The new system, thus, eliminates paper work, facilitates automatic and transparent trading in scrips, shortens the settlement period and ultimately contributes to the liquidity of investment in securities. This system is also known as 'scripless trading system'.

**Constituents of depository system:**

There are essentially four players in the depository system:

(i) The Depository Participant

(ii) The Beneficial Owner/Investor

(iii) the Issuer

(iv) The depository