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LECTURE-8

1.4.2 Classification of Financial Markets

Financial markets can be classified in various types based on the different characteristics.

One way is to classify financial markets by the type of financial claim. The debt market is the financial market for fixed claims (debt instruments) and the equity market is the financial market for residual claims (equity instruments).

A second way is to classify financial markets by the maturity of claims. The market for short-term financial claims is referred to as the money market and the market for Long-term financial cli.1ims is called the capital market traditionally the cut-off between short-term and long-term financial claims has been one year-though this dividing line is arbitrary, it is widely accepted. Since short-term financial claims are almost invariably debt claims, the money market is the market for short-term debt instruments. The capital market is the market for long-term debt instruments and equity instruments.

A third way to classify financial markets is based on whether the claims represent new issues or outstanding issues. The market where issuers sell new claims is referred to as the primary market and the market where investors trade outstanding securities is called the secondary market

A fourth way to classify financial markets is by the timing of delivery. A cash or spot market is one where the delivery occurs immediately and a forward or futures market is one where the delivery occurs at a pre-determined time in future

A fifth way to classify financial markets is by the nature of its organisational structure. An exchange-traded market is characterised by a centralised organisation with standardised procedures. An over-the counter market is a decentralised market with customised procedures.

We will concentrate on classification as per seasoning of claims:

Primary market

Secondary market

Both primary market and secondary market are parts of Capital market. **The capital market** is a financial relationship created by a number of institutions and arrangements that allows suppliers and demanders of long term funds to make transactions. It is a market for long term funds. The backbone of the capital market is formed by various securities exchanges that provide a forum for equity (equity market) transactions.

Primary Market / New Issue Market / Initial Public Offering Markets: The primary market deals with the issue of new securities , that is, securities which are not previously available, It provides additional funds to the issuing companies either for starting a new enterprise or for the expansion or diversification of the existing one and, therefore its contribution to company financing is direct. The primary market is not rooted in any particular spot and have no geographical existence. It is recognized only by the services it renders to lenders and borrowers of capital funds at the time of a particular operation.

Functions of primary market

The general function of primary market, namely, channelizing of investible funds in to industrial enterprises, can be spilt in to three services, which are as follows:

Origination: The term origination refers to the work of investigation and analysis and processing of new proposals. These functions are performed by specialist agencies which act as sponsors of the issue. The preliminary investigation entails careful study of technical, economical, financial, and legal aspects of the issuing companies. This is to ensure that it warrants the backing of the issue houses in the sense of lending their name to the - company and, thus, ,give the issue the stamp of respectability, to satisfy themselves that the company is strongly based, has good market prospects, is well-managed and ;is worthy of stock exchange quotation. In the process of origination the sponsoring institutions render, as a second function, some service of an advisory nature which goes to improve the quality of capital issues. These services include advice on such aspects of capital issues as: (i) determination of the class of securities to be issued and price of the issues in the light of market conditions" (ii) the timing and magnitude e of issues, (iii) methods of flotation, and (iv) technique of selling, and so on market.

Underwriting: To ensure success of an issue, the second specialist service underwriting provided by the institutional setup of the NIM takes the form of a guarantee that the issues would be sold by eliminating the risk arising from uncertainty of public response. That adequate institutional arrangement for the provision of underwriting' is of crucial significance both to the issuing companies as well as the investing public cannot be overstressed.

Distribution: The, sale of securities to the ultimate investors is referred to as distribution; It is a specialist job which can best be performed by brokers and dealers in securities, who maintain regular and direct contact with the ultimate investors.

Secondary Market/ Stock exchange / Security Market: The secondary market deals in to old securities, which may be defined as securities which have been issued already and listed on a stock exchange. The stock exchanges, therefore, provide regular and continuous market for buying and selling of securities and to that extent, lend liquidity and marketability play an important part in the process. Their role regarding supply of capital is indirect. The secondary markets can in no circumstance supply additional funds since the company is not involved in the transaction. The stock exchanges have physical existence and located in particular geographical areas.

Functions of secondary markets: Stock exchanges discharge following three vital functions in the orderly growth of capital formation:

Nexus between savings and investments: First and foremost, they are the nexus between the savings and the investment of the community. The savings of the community are mobilized and channelled by stock exchanges for investment in to those sectors and units which are favored by the community at large, on the basis of such criteria as good return, appreciation of capital, and so on. It is the preference of investors for individual units a well as industry groups, which is reflected in the share price, that decides the mode of investment. Stock exchanges render this service by arranging for the preliminary distribution of new issues of capital, offered through prospectus, as also offers for sale of existing securities, in an orderly and systematic manner. They themselves administrator the same, by ensuring that the various requisites of listing are duly complied with Members of stock exchanges also assist in the flotation of new issues by acting (i) as brokers, in which capacity they, *inter alia,* try to procure subscription from investors spread all over the country, and (ii) as underwriters.

Market Place: They provide a market place for the purchase and sale of securities, thereby enabling their free transferability through several successive stages from the original subscriber to the never-ending stream of buyers, who may be buying them today to sell them at a later date for a variety of considerations like meeting their own needs of liquidity, shuffling their investment portfolios to gear up for the ever-changing market situations, and so on. Since the point of aggregate sale and purchase is centralised, with a multiplicity of buyers and sellers at any point of time, by and large, a seller has a ready purchaser and a purchaser has a ready seller at a price which can be said to be competitive. This guarantees sales ability to one who has already invested and surety of purchase to the other who desires to invest.

Continuous Price Formation: The third major function, discharged by the stock exchanges is the process of continuous price formation. The collective judgment of many people operating simultaneously in the market, resulting in the emergence of a large number of buyers and sellers at any point of time, has the effect of bringing about changes in the levels of security prices in small graduations, thereby evening out wide swings in prices. The ever-changing demand and supply conditions result in a continuous revaluation of assets, with today's prices being yesterday's prices, altered, corrected, and adjusted, and tomorrows values being again today's values altered, corrected and adjusted. The process is an unending one. Stock exchanges thus act as a barometer of the state of health of the nations economy, by constantly measuring its progress or otherwise. An investor can always have his eyes turned towards the stock exchanges to know, at any point of time, the value of the investments and plan his personal needs accordingly.

1.4.3 Efficiency of Financial System

The real test of development of financial system is its efficiency in operations and functional roles. The operational efficiency is reflected in the costs of intermediation, quality of service and its width. The improved operational efficiency during the nineties is seen from significant reforms in the capital market and stock markets, lowering of costs of credit and greater flow of bank credit into these markets, lowering of costs raising funds from the capital market through the route of book building and private placement. The strengthening of the institutions evidences the Width of Services Structure and increasing the instruments of mobilizing funds, introduction of technological innovations in the Stock and Capital markets and in the banking system, deregulation, privatization and globalization of markets and freer flow of funds into and outside country etc. The reforms in general and increasing role of technology and competitive forces in particular have improved the quality of service.

Any financial system can be assessed for its functional efficiency through following criteria in general:

Quantity of funds raised through saving for investment and pattern of allocation from less to more productive purposes.

Its contribution to economic growth and its impact on real economic variables, reflected in market capitalization as a proportion of GDP and the usual ratios, such as Finance ratio - ratio of total issues to national income; Financial interrelations ratio -ratio of total issues to net domestic capital, formation; and financial intermediation ratio -ratio of secondary issues raised by banks and financial institutions to primary issues in the market

Information absorption - whether all information a market and economy are fully reflected in the scrip prices.

Fundamental valuation efficiency - whether the company valuation are reflected in scrip prices.

1.4.4 Skeleton of the Financial System

A radical restructuring of the economic system consisting of industrial deregulation, liberalization of policies relating to foreign direct investment, public enterprise reforms, reforms of taxation system, trade liberalization and financial sector reforms have been initiated in 1992-

Financial sector reforms in the area of commercial banking, capital markets and non-banking finance companies have also been undertaken.

The focus of reforms in the financial markets has been on removing the structural weaknesses and developing the markets on sound lines. The money and foreign exchange market reforms have attempted to broaden and deepen them. Reforms in the government securities market sought to smoothen the maturity structure of debt, raising of debt at close-to-market rates and improving the liquidity of government securities by developing an active secondary market. In the capital market the focus of reforms has been on strengthening the disclosure standards, developing the market infrastructure and strengthening the risk management systems at stock exchanges to protect the integrity and safety of the market. Elements of the structural reforms in various market segments are introduction of free pricing of financial assets such as interest rate on government securities, pricing of capital issues and exchange rate, the enlargement of the number of participants and introduction of new instruments.

Improving financial soundness and credibility of banks is a part of banking reforms undertaken by the RBI, a regulatory and supervisory agency over commercial banks under the Banking Companies Regulation Act 1949. The improvement of financial health of banks is sought to be achieved by capital adequacy norms in relation to the risks to which banks are exposed, prudential norms for income recognition and provision of bad debts The removal of external constraints in norms of pre-emption of funds benefits and prudential regulation and recapitalization and writing down of capital base are reflected in the relatively clean and healthy balance sheets of banks. The reform process has, however, accentuated the inherent weaknesses of public sector dominated banking systems. There is a need to further improve financial soundness and to measure up to the increasing competition that a fast liberalizing and globalizing economy would bring to the Indian banking system.

In the area of capital market, the Securities and Exchange Board of India (SEBI) was set up in 1992 to protect the interests of investors in securities and to promote development and regulation of the securities market. SEBI has issued guidelines for primary markets, stipulating access to capital market to improve the quality of public issues, allotment of shares, private placement, book building, takeover of companies and venture capital In the area of secondary markets, measures to control volatility and transparency in dealings by modifying the backend system, laying down insider regulations to protect integrity of markets, uniform settlement introduction of screen based online trading, dematerializing shares by setting up depositor and trading in derivative securities (stock index futures). There is a sea change in the institutional and regulatory environment in the capital market area.

In regard to Non-Bank Finance Companies (NBFCs), the Reserve Bank of India has issued several measures aimed at encouraging disciplined NBFCs, which run on sound business principles. The measures seek to protect the interests of depositors and provide more effective, prevision, particularly over those, which accept public deposits. The regulations stipulate upper limit for public deposits, which NBFCs can accept. This limit is linked to credit rating an approved rating agency. An upper limit is also placed on the rate of interest on deposits order to restrain NBFCs from offering incentives and mobilizing excessive deposits, which they may not be able to service. The heterogeneous nature, number, size, functions (deployment funds) and level of managerial competence of the NBFCs affect their effective regulation.

Since the liberalization of the economy in 1992-93 and the initiation of reform measure the financial system is getting market-oriented. Market efficiency would be reflected in the wide dissemination of information, reduction of transaction costs and allocation of capital the most productive users. Further, freeing the financial system from government interference has been an important element of economic reforms.

Interpreting Bond and Stock Price Quotations: The financial manager needs to stay abreast of the marker values of the firm’s outstanding bonds and stocks, whether they are traded on an organized exchange, over the counter, or in international markets. Similarly, existing and prospective bondholders and stockholders need to monitor the prices of the securities they own. These prices are important because they represent the current value of their investment. Information on bonds, stocks, and other securities is contained in quotations, which include current price data along with statistics on recent price behavior. Security price quotations are readily available for actively traded bonds and stocks. The most up-to-date '"quotes" can be obtained electronically, via a personal computer. Price information is available from stockbrokers and is widely published in news media-both financial and non financial. Popular sources of daily security price quotations are financial newspapers, such as the Economic Times and the Business Standard, or the business sections of daily general newspapers published in most major cities. Important To update yourself on regular basis read financial newspapers on regular basis.

1.5 TIME VALUE OF MONEY

Most financial decisions, such as the purchase of assets or procurement of funds, affect the firm's cash flows in different time periods. For example, if fixed asset are purchased it will require immediate cash outlays sand will generate cash flows during many future periods. Similarly, if firm borrows funds from the bank it receives cash now and commits an obligation to pay interest and repay principal in future periods. Cash flows become logically comparable when they are appropriately adjusted for their differences in time and risk.

The recognition of the time value of money and risk is extremely vital in financial decision-making. If the timing and risk of cash floes is not considered, the firm may make decision, which may allow too its objectives of maximize the owner's welfare. The welfare of the owners would be maximized when net worth or net value is created from making a financial decision. What is Net Present Value? It's a time value concept. Money has time value. A rupee today is more valuable then a rupee a year hence.

Reasons for individual's Time Preference for Money:

Uncertainty: An individual is not certain about future cash receipts, he prefers receiving cash now.

Preference for Consumption: Most people have subjective preference for present consumption over future consumption of goods and services either because of the urgency of their present wants or because of the risk of not being in a position to enjoy future consumption that may be caused by illness or death. As money is the means by which individuals acquire most goods and services, they may prefer to money have now.

Investment Opportunities: Most individuals prefer present cash to future cash because of the available opportunities to which they can put present cash to earn additional cash. For e.g., an individual who is offered Rs. 100 now or Rs 100 one year from now would prefer Rs100 now if he could earn interest of Rs 5 by putting in the saving account in the bank for one year. His total cash in one year from now will be Rs.105.