Indian Financial System

For B Com Honours Degree Course of University of Calcutta

Sujatra Bhattacharyya

Assistant Professor and Head of Department of Economics
Maharaja Srischandra College

OXFORD
UNIVERSITY PRESS

OXFORD
UNIVERSITY PRESS

Oxford University Press is a department of the University of Oxford. It furthers the University's objective of excellence in research, scholarship, and education by publishing worldwide. Oxford is a registered trademark of Oxford University Press in the UK and in certain other countries.

Published in India by
Oxford University Press
Ground Floor, 2/11, Ansari Road, Daryaganj, New Delhi 110002, India

First published in 2017

ISBN-13: 978-0-19-947935-1
ISBN-10: 0-19-947935-6

Typeset in Baskerville MT STD
by Versatile PreMedia Services (P) Ltd., Kharadi, Pune 411 014
Printed in India by Magic International (P) Ltd., Greater Noida

Cover image: greenaperture / Shutterstock

Features of

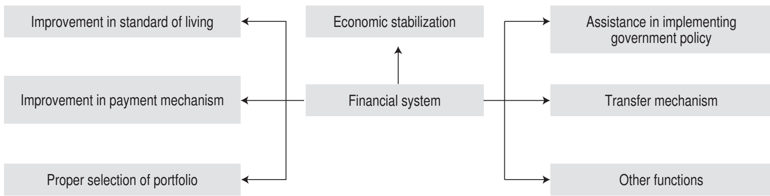

Fig. 1.6 Functions of a financial system

Figures The chapters contain numerous well-labelled figures and flowcharts to enhance the assimilation of the topics.

Tables The chapters contain numerous detailed tables to support the text.

Table 1.2 Differences between fund-based financial services and fee-based financial services

Basis of Difference	Fund-based Services	Fee-based Services
Nature	They provide funds to the business units to meet their requirements	They provide advisory services to their clients and charge fees against their services
Risk	These institutions provide funds and reduce risks	They only provide advisory services
Objective	The main objective is the provision of capital	Their main objective is provision of various technical, financial, and project-related advices
Remuneration	They earn interest on capital	They earn fees against their advices
Example	Hire-purchase and leasing companies, insurance services, bill discounting, etc	Merchant banking, portfolio consultancy, issue management, etc

GLOSSARY

Banking intermediaries directly participate in the payment mechanism and various transactions. They together can create money or credit.
Capital market is that part of financial market, which deals with the long-term claims and, like money market, ensures the flow of funds from surplus to deficit units.
Direct finance refers to a financial system where savings are directly channelized into investments through the financial market without any intervention of financial intermediaries such as insurance organizations, mutual funds, and other financial institutions.
Fee-based services refer to the specialized services provided by some professionally managed institutions against requisite fees. These services mainly imply technical and financial advices.
Finance is referred to be the mainstay of the economy as it is adequately required to perform various economic activities such as development of infrastructure, creation of employment opportunities, economic development, and establishment of industries.
Financial institutions refer to the institutions that act as intermediaries in the transfer of funds from surplus to deficit units and, thus, mobilize savings in the economy.
Financial instruments or assets, which are heterogeneous in nature, refer to the legal claims associated with a future cash flow.
Financial intermediaries refer to institutions that facilitate the process of transfer of fund from fund providers to fund seekers and, thus, mobilize the savings.
Financial market refers to a centre that provides the facilities of sale and purchase of financial claims and services.
Financial non-intermediaries do not work as a medium between fund providers and fund seekers. They do not accept any deposit from the general public. They actively take part in the business and sometimes invest in the proper sector
Financial regulators refer to institutions that generally try to protect the interest of the investors and maintain the financial discipline of the market.

Glossary Every chapter contains a glossary of key words with definitions to recapitulate important terms.

the Book

Solved CU QPs and Model QPs
The book contains solutions to last three years' university question papers, as well as two model question papers for students to get a feel of examinations.

Solved Question Papers

INDIAN FINANCIAL SYSTEM (2017)

1.

Ans.
finan

Model Question Papers

SET-1

Group-A

1.	Discuss the importance of financial intermediary in the financial system.	5
OR	Distinguish between banking and non-banking financial intermediary.	5
2.	What are the functions of ICICI in Indian financial market?	5
OR	State the importance of SFC in the development of small-scale industries.	5

Question Bank

Chapter 1 The Indian Financial System

1. Define financial system. What is the significance of the financial system?

A financial system is an integral part of the economy. It plays a pivotal role in the overall economic growth of a nation. We can define financial system as a combination of various complex and mutually interdependent financial activities that also acts as connecting link between savers and investors to fulfil a certain and predetermined objective. The financial system acts as an intermediary, which ensures the flow of funds from surplus to deficit units. The financial system performs its basic activities through the components and involves

Question Bank
The book contains a question bank of solved model questions and answers to help the students prepare for examinations.

MCQs and Exercises
Each chapter contains a set of MCQs and review questions for self-evaluation.

MULTIPLE CHOICE QUESTIONS

1. A financial system ensures the flow of funds from
   (a) Investors to savers
   (b) Savers to investors
   (c) Investors to government

4. In which of the following eras, the Indian financial system was characterized by a lack of financial innovation?
   (a) Post-liberalization phase
   (b) In the mid-1960s

EXERCISES

1. Define a financial system. Mention its significance and functions.
2. Write a brief note on the financial system of a country.
3. Explain the role of finance briefly.
4. Show how the fund flows from surplus to deficit units through a financial system?
5. What are the components of a financial system?
6. Explain the significance of financial intermediary.
7. Discuss the role of financial institutions in the financial system.
8. What is the relevance of a financial market in a financial system?
9. What are the functions of financial services institutions in a financial system?
10. Define financial regulator. What is the role of the regulators in the financial system?
11. Discuss the different types of finance in a financial system.
12. Discuss the organizational structure of the Indian financial system with examples.
13. Distinguish between
    (i) Banking and non-banking institutions
    (ii) Fund-based and fee-based financial services
    (iii) Financial intermediary and non-intermediary

Preface

Financial system is closely interlinked with economic development. Basically economic development indicates both qualitative and quantitative aspects. Economists and financial experts relentlessly try to determine the impact of the changes in the financial indicators on economic activities. Some serious efforts have been made to assess the impact of financial activities on capital formation and economic development. The various theoretical and empirical findings are suggestive of significant effects of financial indicators on economic development. However, these financial indicators are not the only ones to affect economic growth. Actually they have a considerable amount of influence over the factors of economic development. Thus it is often believed that a strong and sound financial system acts as a catalyst to economic development. It enhances the standard of living of the people as well as ensures the well-being of the population.

One important aspect of the financial system is its capability to encourage the rate of savings and investment in the economy. An ideal and efficient financial system has the capability of filling the gap between investment and savings potential of the economy and thereby, mobilizing the savings. The specialty of the financial system is that it not only initiates investment but also directs the investible fund into the productive sectors of the economy. This definitely leads to greater possibilities of economic development. On the other hand, the economic development of a nation increases the efficiency of the financial system. Thus we observe some sort of complementarity between a financial system and economic development.

India is one of the emerging developing nations which is expected to be a superpower in the near future. The recent development in the nation owes significantly to the financial sector reforms since 1991, when the country adopted the strategy of liberalization, privatization, and globalization. Naturally the robust growth of the economy is a matter of interest among the economists and financial experts. The book *Indian Financial System* comprises various financial aspects of Indian economy and presents a detailed idea about the operations in the financial market. The Indian financial system is now going through a phase of alterations and introduction of new techniques, rules, and regulations. This is a part of the strategy of turning the Indian financial system compatible with the financial systems of the developed nations. The financial sector reforms are going to change the financial habits of the population. The government puts emphasis on the digitalization of the financial transactions. A combination of all these changes and the existing traditional modes make the Indian financial system an interesting one. This has motivated me to write a book on the Indian financial system in a lucid manner so that it is easily comprehensible to the students.

ABOUT THE BOOK

This book is mainly designed for the third year students of B Com (Hons) course under University of Calcutta. Apart from this, the book will also be useful for the students pursuing commerce course in graduation in other universities. The students of professional courses will also find the necessary materials and inputs from the book which will meet their requirements. Above all, the young researchers in this field can gather the basic and preliminary ideas and information from this book.

The objective of the book is to make the readers aware of the various aspects of the Indian financial system and financial market operations. The book provides theoretical knowledge of the components of the financial system with appropriate examples. As an author I have made an effort to provide the readers what are not available in the existing books. Besides, I have tried to explain the contents of the chapters in a lucid manner for the benefit of the students. Thus we are hopeful that this book will not merely be an addition to the already existing corpus in this field, but will also be able to create a unique and separate identity due to its special features.

The key features of the book are as follows:

- The book clearly mentions the learning objectives at the beginning of the chapters which will enable the students to be focused.
- The chapters are written in a simple lucid style so that the students can independently extract the matters for their use.
- The contents are prepared with the objective of providing conceptual understanding and logical explanations to the students.
- One of the most important features of the book is the simple diagrammatic representation of most of the subject matter through figures and flow charts.
- Current and latest data are incorporated in the subject matter for better understanding of the trends of various macroeconomic indicators.
- Some topics are accompanied by graphical representation so that the students can grasp the subject matter conveniently.
- All chapters end with multiple choice questions and review questions which will help the students apply the concepts learnt in the chapters.
- The detailed summary and glossary at the end of every chapter will help the students in a quick understanding of the contents and subject matter.
- The important and extremely relevant portions of the subject matter are highlighted so that the students can focus on them.
- The book also comprises solved CU question papers of the last three years and two model questions which will benefit the students immensely.
- At the end of the book a Question Bank has been introduced which comprises around 60 solved questions, collected from different university examinations. This will provide guidance to the students on how to construct answers to the questions.

CONTENTS

This book is comprised of 10 chapters which present the Indian financial system in a detailed manner.

Chapter 1 deals with the basics of the financial system and its components. It mainly focuses on the activities of financial intermediaries and also provides description about the structure of Indian financial system and its recent changes.

Chapter 2 provides a fair idea about money and banking. Here, I have explained the different variations of money, structure, and functions of the commercial banks and finally the functions and monetary policies of Reserve Bank of India (RBI) and the recent changes.

Chapter 3 illustrates the objectives and functions of development banks like IFCI, IDBI, ICICI, NABARD, SFC, EXIM Bank, etc. and focuses on the operational activities of them.

Chapter 4 covers other financial institutions like LICI, GICI, and UTI. The chapter not only focuses on the objectives and functions of these institutions but also discusses their activities after liberalization. Besides this, the chapter provides information about mutual funds and IRDA.

Chapter 5 explains the interest rate structure of the economy and differentiates gross and net interest. It shows the methods of determination of equilibrium rate of interest and also identifies the reasons for the differential interest rate.

Chapter 6 gives an overview of the financial markets by mentioning different financial instruments and derivative techniques like forward, future, and options.

Chapter 7 focuses on the features, functions, and different types of money market. It further discusses call money market in detail and informs about the money market reforms after liberalization.

Chapter 8 provides detailed analyses of features, functions, divisions, and participants of capital market. The chapter clearly distinguishes the features of primary and secondary market and also discusses every aspect of the stock exchange.

Chapter 9 shows the protection measures for the investors and provides remedies to the investors' grievances. It assesses the role of SEBI, court, and media in protecting the interest of the investors.

Chapter 10 describes the details of financial services. In this chapter the merchant banks and the credit rating agencies are analysed. It also provides a detailed view of the objectives and activities of the merchant banks and the credit rating agencies.

ACKNOWLEDGEMENTS

I have received active support and motivation from a number of persons for writing this book. My parents have always been there to inspire me throughout this long journey. I am grateful to my teachers who taught me the basics of the subject. The support I have received from my elder brother Mr Dipra Bhattacharya, my sisters-in-law Aishee and Writi, and my in-laws is fabulous. My wife Prof. Debashree Bhattacharya has not only helped me focus only on the writing by sharing the entire burden at home singlehanded but also rendered assistance to prepare the content. My student Prof. Sucharita Bhattacharyya of Barasat College has actively participated in preparing study material by investing her time and hard work affectionately. My student Prof. Soumya Mukherjee of Maharaja Manindrachandra College has also helped me in different publication-related matters.

I am also indebted to my supervisors Prof. Arup Mitra of Institute of Economic Growth, New Delhi, and Dr Asim Karmakar, my Principal Dr Shyamal Kumar Chakraborty, Prof. Sidhdhartha Majumdar of City College, and Prof. Asis Sana of University of Calcutta for continuous guidance and advice. Prof. Biswajit Chatterjee of Jadavpur University, Prof. Santanu Ghosh of Maulana Azad College, and Dr Indrani Saha of Sri Sikhshayatan College have always encouraged me to pursue this sort of work. My colleagues of Maharaja Srischandra College are as usual cooperative and I should name Prof. Soma Sengupta, Dr Sunanda Ray, Dr Sonali Banerjee, Debjani Kundu, Anindita Bhattacharyya, Debasis Mukherjee, Bidyut Sarkar, Dr Asim Das, Dr Avijit Chakraborty, Dr Debasree De, Sara Basu, Prof. Pradip Mukherjee, Prof. Prabir Dutta, Sarita Mal, and Amrita Kundu for their tremendous support. The teachers of the Department of Commerce—Arup Kr Bhattacharya, Dr Supti Kotal, Krishnapada Dash, Sreya Basu, Debjani Kundu, and Camellia Sarkar have also motivated me a lot during this project. Supriya Bhattacharyya has provided relevant advice and inputs in constructing the subject matter. Nabarun Bhattacharyya, Kuntal Mitra, Amit Ray, and Sudipta Bhattacharyya were always present with their extended hands of cooperation, technical support, and motivation throughout the journey. Prof. Debjani Lahiri of our college and Mita Dutta, the educator at Dakshineswar Sri Sri Sarada Devi Balika Vidyamandir have also rendered their assistance in preparing the course material.

My heartfelt thanks and gratitude to those friends who helped me, choosing to remain invisible themselves.

I am also extremely grateful to the editorial and sales teams of Oxford University Press for their patience and inspiration which boosted me to complete the project finally.

Feedback and suggestions for improving the future editions are always welcome and can be sent to the author at sujatra_bh@rediffmail.com.

Sujatra Bhattacharyya

Contents

Road Map to Indian Financial System

MODULE 1

Unit	Topic	Details	Chapter
Unit I	Financial System	Meaning and significance; Role of finance in an economy; Components (instruments, markets, etc.); Kinds of finance – Rudimentary finance, direct and indirect finance; Role of financial intermediaries; The structure of Indian financial system	1
Unit II	Money and Indian Banking System	Functions; Alternate measures to money supply in India – Their different components; Commercial banks – Importance and functions; Structure of commercial banking system in India; Distinction between commercial and central bank; Credit creation process of commercial banks; High powered money – meaning and uses – Concept of money multiplier The Reserve Bank of India: Functions; Instruments of monetary and credit control; Main features of monetary policy since independence	2
Unit III	Development Banks	Concept of development banks, and their needs in Indian financial system – Differences with commercial banks – Major development banks and their functions (IFCI, IDBI, ICICI, EXIM Bank, SIDBI, SECs, NABARD)	3
Unit IV	Other Financial Institutions	Introduction; Life Insurance Corporation of India, General Insurance Corporation of India, Unit Trust of India	4
Unit V	Interest Rate Structure	Meaning – gross and net interest rate – their difference; Nominal and real interest rate – their difference; Differential interest rate, Causes of variation of interest rate, relationship between interest rate and economic progress; Administered and market-determined interest rate; Recent changes in interest rate structure in India	5

MODULE 2

Unit	Topic	Details	Chapter
Unit I	Overview	An Overview of Financial Markets in India	6
Unit II	Money Market	Concept; Structure of Indian money market, Acceptance houses; Call money market; Recent trends of Indian money markets	7
Unit III	Capital Market	Concept; Security market, Primary and secondary markets – Functions and role; Functionaries of stock exchanges – Brokers, sub-brokers, jobbers, consultants, institutional investors, and NRIs	8
Unit IV	Investor's Protection	Grievances concerning stock exchange dealings and their removal, Grievance redressal cell in stock exchanges; Role of the SEBI; Company Law Board, Judiciary and media	9
Unit V	Financial Services	Merchant banking – Functions and roles; SEBI guidelines; Credit rating – concept & types, functions and limitations; Profile of Indian rating agencies	10

CHAPTER

6 An Overview of Financial Markets in India

Learning Objectives

After studying this chapter, you should be able to

- understand the features, roles, and classifications of the financial market
- identify the variations in the organized and unorganized financial market
- recognize the features and functions of the foreign exchange market
- explain the features of the derivatives
- classify the different derivatives
- understand the concepts and features of forward, future, options, and swaps
- distinguish between forward and future, future and options, and call option and put option
- identify the regulators of the Indian financial market

6.1 INTRODUCTION

Financial market refers to a centre that provides the facilities of sale and purchase of financial claims and services. The individuals, financial institutions, corporations, and government trade in this market either directly or indirectly through brokers and dealers. If we want to analyse the financial market of a nation, then initially, we should concentrate on the various financial markets of that nation, various financial institutions operating on those markets, and the financial instruments and services available in those markets.

The financial market generally plays a vital role in transferring funds of the surplus units into the productive sectors of the economy. Thus, this market is involved in proper channelization of savings, which in turn leads to the capital formation and economic development. Allocation of funds into the productive sectors of the economy implies a growth in the national income (Fig. 6.1).

6.2 FEATURES OF THE INDIAN FINANCIAL MARKET

The effectiveness of financial system is one of the main determinants of the economic development. However, the efficacy of the financial system hugely depends on the working capacity of the financial market. In that sense, financial market plays a vital role in the balanced economic development of the nation. The basic essence of financial market cannot be properly understood without analysing the features of the financial market. Hence, it will be convenient for the readers if we will discuss the features of financial market in the following way

1. **Coexistence of organized and unorganized segments** Indian financial market is characterized by the coexistence of organized and unorganized segments. The organized financial market comprises commercial banks, cooperative banks, and development banks. The regulators in this segment are

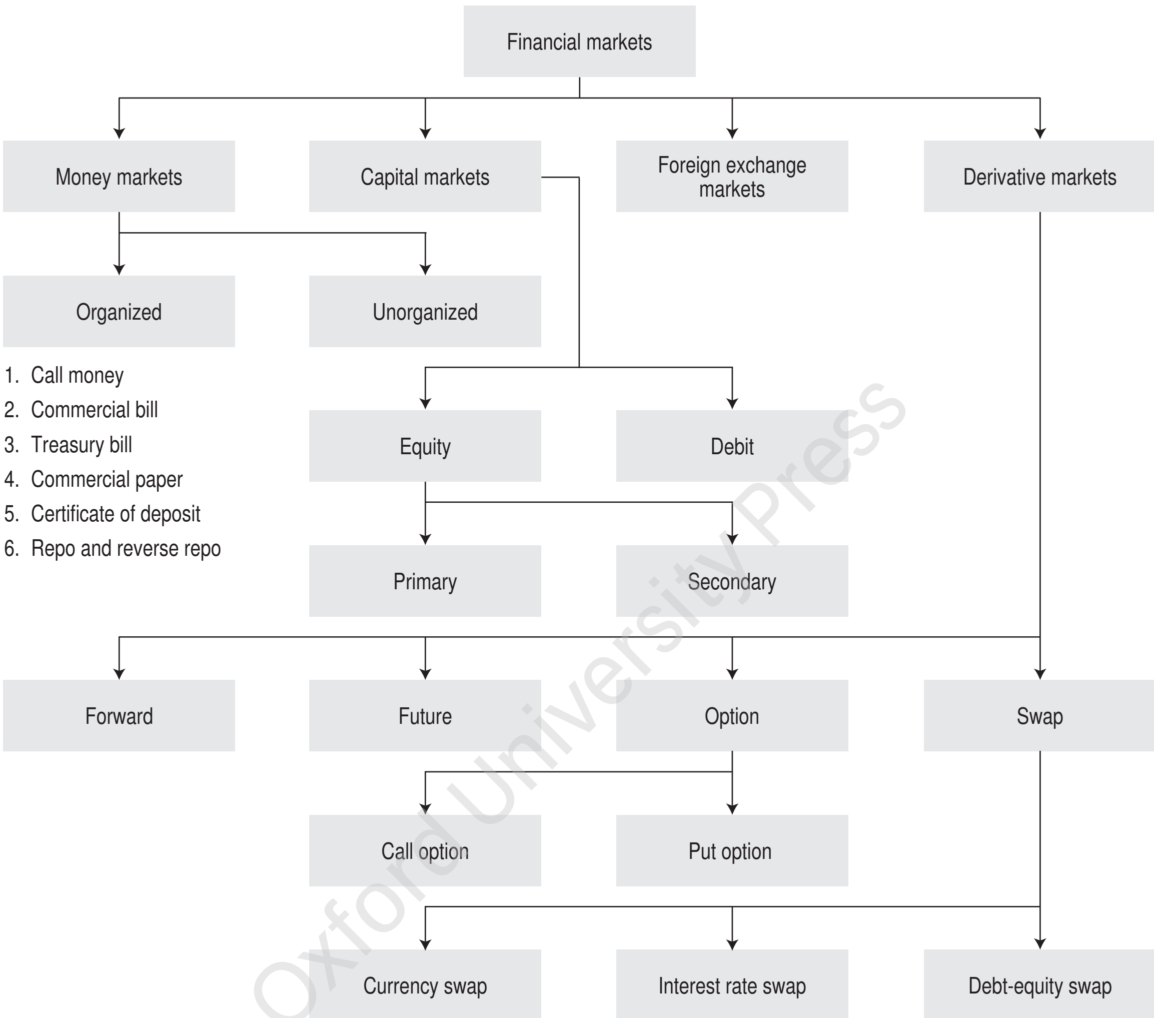

Fig. 6.1 Financial market

Reserve Bank of India (RBI), Security and Exchange Board of India (SEBI), etc. Conversely, the participants in the unorganized segment are beyond the control of the regulators. The rural moneylenders occupy a significant portion of unorganized market.

2. **Insufficient participation** In India, the per capita income is low, which leads to a low rate of savings and investment. The low rate of savings is responsible for insufficient participation of investors in the financial market.
3. **Mobilization of savings** The financial market acts as the medium in the process of transfer of funds from savers to investors. Indian financial market also ensures flow of funds from savers to the productive sectors of the economy.
4. **Presence of regulatory bodies** The Indian financial market comprises both money and capital market, which are regulated by some institutions such as Ministry of Finance, RBI, SEBI, Insurance Regulatory and Development Authority (IRDA), and National Company Law Tribunal (NCLT).

5. **Faulty banking network** In India, most of the scheduled commercial banks are interested to establish their branches in the urban areas for profit motive. Hence, the number of banks in the rural areas is very limited. This leads to an unbalanced development in the banking sector.
6. **Inefficient capital market** The efficiency of the Indian capital market is not up to the mark. Before the adoption of the new economic policy in 1991, the capital market was ill-developed. However, after the adoption of new economic policy, there were a lot of positive changes in the capital market. Foreign capital was flown to Indian capital market. Thus, there was an improvement but was definitely insufficient.
7. **Limited coordination** Since a significant portion of the financial market in India is characterized by unorganized segment, there was clearly a lack of coordination between the different units of the Indian financial market.
8. **Lopsided development** The financial markets in India are not equally developed in different regions. The financial markets are fragmented, and accordingly, the coordination among them is not so strong. Thus, the Indian financial market is characterized by lopsided development.
9. **Parallel economy** In India, besides the conventional economy, we observe a parallel economy where the transactions occur without any specific rules and regulations. This leads to the generation of unaccounted or black money in the financial system.
10. **Paucity of financial instruments** As the financial market in India is not that vast, the possibility of introducing new financial markets is very limited. Though, after 1991, when the new economic policy was adopted, some measures were taken to develop the capital market. Some new financial instruments are introduced in recent times also. However, there is a long way to travel, as still we have a very limited usage of the financial instruments compared to the other developed nation of the world.
11. **Huge corruptions and scam** The Indian financial market experienced huge corruptions and scams. The scams related to Harshad Mehta and Ketan Parekh destroyed the faith of investors on the financial market. Government of India established SEBI in 1992 to prevent the malpractices specifically in the Indian financial market.

However, the financial market in India helps to develop the financial system, assists in the process of capital formation, helps in transaction, and plays an important part in increasing the volume of trade. Apart from this, an efficient financial market leads to creation of new job opportunities in India.

6.3 CLASSIFICATION OF FINANCIAL MARKETS IN INDIA

We can classify the Indian financial market into the following categories:

(i) money market
(ii) capital market
(iii) foreign exchange market
(iv) derivative market

Many financial experts classify the Indian financial market in a different way, and a few considered the derivative market as a part of the Indian capital market. However, we have considered derivative market as a separate part since it is not only related to equity but also to currency and commodity. Now, we will briefly explain the different parts of the Indian financial market briefly, because most of these components will be discussed in a broader way in the subsequent chapters.

6.3.1 Money Market

The financial market that deals with short-term securities and claims (with a period of maturity of 1 year or less) is known as money market. Indian money market plays a significant role in the economic system as it efficiently ensures the transfer of funds from savers to investors. The short-term surpluses of the fund providers are channelized into the hands of fund seekers. Here, the short term refers to the time period between 1 day and 1 year. The main instruments for the short-term transactions in this market are bank draft, cheques, bill of exchange, and pay-orders.

Indian money market can be subdivided into

(i) organized money market (ii) unorganized money market

6.3.1.1 Organized money market

The part of money market where financial transactions occur according to proper regulations and norms is known as organized money market. In India, the organized money market comprises RBI, nationalized commercial banks, cooperative banks, insurance organizations, development banks, mutual funds, etc. There is a close interlinkage among the various units of this market, and, hence, the components of this market are organized and compact. Indian organized money market comprises:

1. **Call money market** The part of the money market where day-to-day transactions of surplus funds occur is known as call money market. This market provides short-term funds, and the time of repayment varies from 1 to 14 days. Call money has the maximum liquidity and considered as a very safe loan.
   In India, the scheduled commercial banks, discount and finance house of India, and many primary dealers participate in this market. The other financial institutions and mutual funds can only provide loans in this market. The call money market basically meets the temporary crisis of funds and protects the cash reserve ratio of the banks. In India, the call money market is very much controlled and narrow. The entry is restricted, and, hence, there are a number of borrowers in the market but the number of lenders is very few. That is why the participants in this market do not get any active market. However, the situations have changed after 1985 where committees of both Chakraborty and Bhagal recommended increasing the activity of the call money market.
2. **Commercial bill market** The market in which we observe the transactions of commercial bills is known as the commercial bill market. Now, commercial bills refer to the bills against which the industrial and business concerns receive short-term loans from the commercial banks. These short-term loans are received to meet the requirement of the circulating capital.
   The commercial bills involve three parties such as drawer or bill-preparer, drawee or bill-subscriber, and payee. The commercial bills are in the written form, which should be signed for authenticity. Generally, the use of commercial bills enhances the size of goods market, provides liquidity, and expands credit facilities. It is transferable and legally authenticated.
3. **Treasury bill market** Treasury bill refers to a commercial bill or a financial instrument issued by the central bank on behalf of the government to meet the short-term liquidity problem. The market in which the transactions of the treasury bills occur is known as treasury bill market. In India, RBI has the power to issue the treasury bills. However, prior to 1950, the state governments also accumulate funds through the treasury bills. Treasury bills are very useful in bridging the gap of the fiscal deficits.
   The treasury bills are basically liquid in nature, which involve a very low transaction cost. Since it is issued by the government, the risk associated is minimal. On the basis of the tenure, the treasury bills are of four types—14-, 91-, 182-, and 364-day T-bills.
   Although treasury bills have numerous advantages, still the Indian T-bill market is ill-developed. Even after 1991, when most of the restrictions are withdrawn, the T-bill market failed to reach its optimum level in India.
4. **Certificate of deposit market** Certificate of deposits that are issued by the commercial banks and development financial institutions in bearer forms refer to the short-term and unsecured negotiable instruments. The market in which they are traded in exchange is known as certificate of deposit market.

Certificate of deposit was introduced in India in June 1989. The commercial banks accept the term-deposits by issuing this type of certificates. This certificate is transferable in nature whose tenure varies from 15 days to 1 year. The minimum amount deposited is fixed at ₹ 100,000.

5. **Commercial paper market** The commercial paper, that is negotiable in nature, implies a short-term promissory note issued by the big and highly rated companies. The market that deals with commercial papers is known as commercial bill market. These are issued by the companies to raise the short-term fund required for working capital. The commercial papers are unsecured and can be exchanged.
   Commercial papers are used in India since 1990. An individual, an institution, a company, or a bank can invest in commercial papers. Generally, the tenure varies from 7 days to 1 year, and the minimum amount required for investment is ₹ 5 million. In India, the commercial paper market plays a significant role.
6. **Repo and reverse repo** Repo and reverse-repo are one of the latest inclusions in the money market, which are compatible with the recent diversifications in the financial market in India. All these diversifications actually strengthen the financial markets of India.
   Repo or repurchase agreement is the transaction in which a financial institution or a bank receives funds immediately by selling securities with an agreement to repurchase the same at a specified pre-determined price after a specific time period. Hence, repo is applicable only if there is a short-term crisis of funds. Conversely, in case of reverse repo, a financial institution or a bank purchases a security with an agreement to sell it back on a specific date at a pre-determined price.

Apart from the above-mentioned components, the mutual funds and inter-bank participation certificates are also notable, which will be discussed elaborately in the subsequent chapters.

6.3.1.2 Unorganized money market

The part of the money marker where all the transaction occurs without any regulations or norms is known as unorganized money market. In the unorganized market, there is a very weak linkage among the various units. In India, the unorganized market occupies a significant portion of the money market. Often, their activities are beyond the control of RBI.

The important components of the unorganized financial market in India are local moneylenders, rural moneylenders, chit funds, business person, shroffs, etc. The organized sectors are not interested to operate in the rural economy due to low profit potential. Hence, the unorganized sector grabs the opportunities of investing in the rural economy of India. Naturally, the lending rate is very high in the rural sector, which leads to a considerable amount of exploitation of the rural mass. The economic development varies inversely with the presence of unorganized sector in the economy.

6.3.2 Capital Market

The financial market that deals with the long-term claims and like money market ensures the flow of funds from surplus to deficit units is known as capital market. This market provides long-term finance (with a period of maturity of more than 1 year) to the trade, industry, and commerce. It is different from the money market on the basis of the period of maturity of the financial assets.

In India, capital market is mainly constituted by investment trust (such as UTI), insurance companies (LICI and GICI), specialized financial institutions (such as IFCI, IDBI, and ICICI), and security market.

The capital market can be subdivided into

(i) equity market or security market
(ii) debt market

Few experts considered derivative market as a part of capital market, but since it involves capital, commodities, and currency, we have considered the derivative market as a separate and distinguished portion of the capital market.

6.3.2.1 Equity market

It refers to capital market that deals with shares and debentures of various joint stock companies. The equity market in India can be subdivided into:

1. **Primary or new issue market** The financial market that deals with new financial claims or securities is known as primary market. As this part of financial market deals with new securities, it is known as 'new issue market'. In the primary market, the securities issued by corporate or government come into the hand of owner.
2. **Secondary market** The financial market that deals with the already existing or new securities is known as secondary market. Thus, in the secondary market, existing securities are sold and purchased. Secondary market is also known as 'stock market' or 'aftermarket'. This market has the capability of providing liquidity to the securities issued in the primary market.

6.3.2.2 Debt market

Debt market essentially indicates the bond market. The debt market occupies a major portion of the financial market, and actually, it covers more than the equity market in terms of volume. The debt market can be classified as corporate debt market, government securities market, and public sector undertaking bond market. This market is able to maintain the liquidity of the financial market. It provides finance to government for developmental activities. However, the principal function of this market is to channelize the surplus fund of the savers to the productive sectors of the economy.

6.3.3 Foreign Exchange Market

Foreign exchange market refers to a market in which domestic currency or claims are exchanged for foreign currencies. In an open economy, foreign exchange market has a vital role to play. It refers to a centre where we observe the transactions between buyers and sellers of foreign exchange. In other words, it is the market in which currency of one nation is exchanged for the currency of the other nation (Fig. 6.2).

6.3.3.1 Features of the foreign exchange market

The basic features of foreign exchange markets are

1. **International transactions** The transactions of one nation with other nations are known as international transactions. The foreign exchange market is the centre of international transactions.

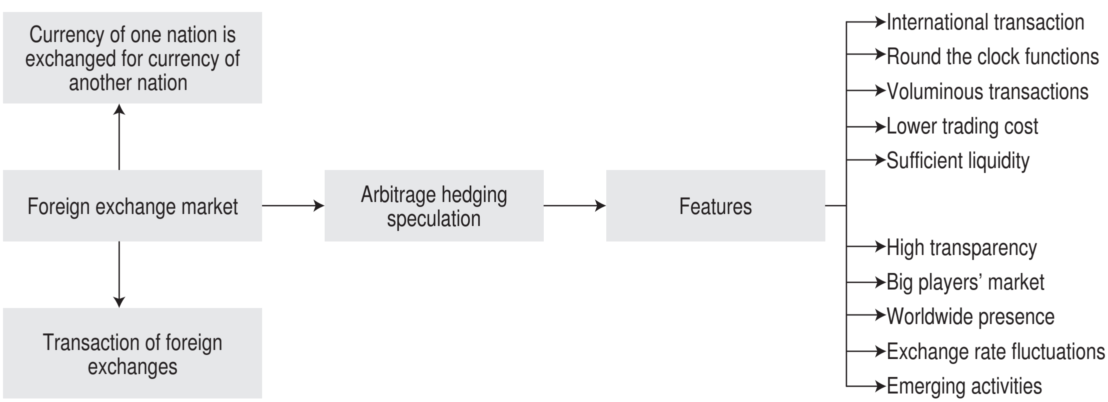

Fig. 6.2 Foreign exchange market

2. **Round the clock functions** Except for the weekends, foreign exchange market is open 24 hours a day. It should be noted that it is the only market that is always open except for the weekends.
3. **Huge volume of transactions** The foreign exchange market is characterized by the presence of a number of big players. Thus, the volume of transactions executed in forex market is huge.
4. **Lower trading costs** The trading cost in the forex market is comparatively low. So, it is possible for the small, individual investors to make a considerable amount of profit from various transactions.
5. **Liquidity** Owing to the presence of numerous big players in the market, the transactions are voluminous. This leads to sufficient liquidity in this market.
6. **Transparency** Transparency in the forex market implies the free access to the trading information. The players in the forex market have the full access to the data and relevant information, which are necessary to perform a profitable transaction. In that sense, forex market is extremely transparent.
7. **Big players' market** The big and reputed banks and the governments of different countries participate in the foreign exchange market as the players. Hence, forex market is known as the big players' market.
8. **Worldwide presence** As the forex market is present in every nation, it can be said that they are located everywhere in the world geographically. This is naturally a unique feature of the forex market.
9. **Exchange rate fluctuations** Since the demand and supply conditions in the foreign exchange market are continuously changing, the market is characterized by exchange rate fluctuations.
10. **Emerging activities** The fluctuations in the exchange rate of the forex market give birth to some activities or professions namely arbitrage, speculation, and hedging. Arbitrage refers to the buying of a currency from the financial centre where it is cheap and simultaneously selling of it where it is expensive. Hedging implies covering or minimizing the risk. Conversely, speculation is the deliberate assumption of the risk associated with fluctuations in the exchange rate.

Thus, foreign exchange market enables the players to perform international transactions. Its transparency and round the clock function increase the volume of transactions and trade. Evidently, the presence of a strong forex market strengthens the financial market of a nation.

6.3.4 Derivative Market

Financial derivative is treated as an integral part of the financial market in these days. It is a well-known fact that the financial market is quite volatile, and, hence, the investors have to take the possibility of risk into consideration for every transaction. This calls for the introduction of the concept of derivative. The derivatives become the most modern financial instruments for minimizing the risk. These instruments are known as 'derivatives' because they derive their values from some underlying assets such as agricultural commodities, shares, currencies, gold, silver, and other commodities. Hence, it is evident that the derivative techniques can be applied in *capital, commodity, and foreign exchange markets*.

Thus, derivatives are defined as written contracts between two different parties, which have no intrinsic value of its own, but it is derived from the underlying assets such as currencies, commodities, and gold. The risk-averse people interact with the risk-lovers through derivatives, and the common place of interaction between them is known as derivative market. In this context, derivatives act as risk-shifting instrument (Fig. 6.3).

6.3.4.1 Features of derivatives

Derivatives have the following features:

- It is an important financial instrument, which is used to *reduce the market risk*.

- It has no intrinsic value of its own—*its value is derived from underlying assets such as commodity, currency, and capital.*
- Derivatives involve *low transaction costs* and *raise liquidity* in the financial system.
- Sometimes, derivatives assist the traders as they *predict the market movements.*
- The presence of derivatives in the financial market *strengthens the composition and depth of the market.*
- Derivatives in the financial market are *used for hedging and speculation.*
- Derivatives are traded globally that indicates their popularity in the financial market.
- The types of derivatives are *forward, future, options, swaps, and warrants.*

6.3.4.2 Classification of derivatives

The popular types of derivatives that are used in the financial market are

- forward contracts
- future contracts
- options
- swaps

We will briefly explain these different derivative techniques of the financial market.

1. **Forward contracts**

   The derivative contract where a buyer and a seller are agreed to exchange a commodity or instrument for cash at a pre-determined price at a pre-determined date, agreed upon today, is known as forward contract.

   The stipulated or the pre-determined price is known as forward price.
   Let on 15 August 2016, company A makes an agreement with company B, that on 15 November 2016, it will buy 2 kg of gold at ₹ 2.5 million/kg. Let on 15 November, the market price (also known as spot price) of per kilogram gold becomes ₹ 30 million which implies a gain of (2 × 30 million − 2 × 25 million) or ₹ 10 million for the buyer. If the contract is cash-settled, then the seller will just pay the profit, that is ₹ 10 million to the buyer rather than giving him 2 kg of gold.

   a) ***Features of forward contract*** The salient features of the forward contracts are:

      i. *Customized contract* The contract between buyer and seller is made according to their mutual decisions. The contract is customized in the sense that it can vary from parties to parties depending on mutual decision-making, which serves the needs of both the parties.

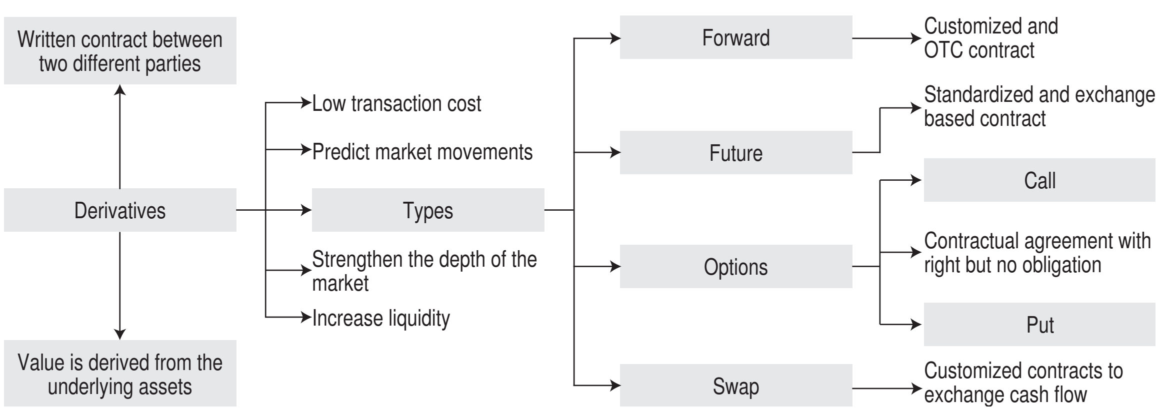

Fig. 6.3 Derivative market

ii. *Settlement of future transactions* In this type of contract, the agreement is made for a transaction in future while the future price and date of transaction are agreed upon today.

iii. *Associated risk* Naturally, the parties involved in the forward contract are exposed to risk during the validity of the contract.

iv. *Settlement* The contract is settled at its date of expiry, when one of the parties make profit in terms of cash or other assets. The forward contracts can be settled by physical delivery of the asset or cash settlement at the date of expiry or delivery date.

v. *Vast applicability* The forward contract can be observed in foreign exchange market, capital market, or commodity market, which shows its vastness and wide acceptability.

vi. *Bilateral* The forward contract is bilateral in nature, which involves a buyer and a seller. The agreements about pre-determined price, delivery date, etc. are negotiated bilaterally by the parties involved.

vii. *Absence of direct cost* One of the reasons for the popularity of the forward contract is the absence of direct cost in this agreement. In case of a cash settlement, the buyer or seller has to pay only the cash difference between agreed upon price and spot price. There is no exchange of money between the parties at the time of making the contract.

viii. *Over-the-counter trade* Forward contracts trade over the counter. Trading of forward contracts on any recognized stock exchange is not familiar.

2. **Future contracts** A future contract refers to a standardized contract between two parties to purchase or sell an asset at a specified time in future for a certain price agreed by the parties involved. It is often termed as a special type of the forward contract, which is standardized in nature and exchange traded. The price agreed upon is known as future price.

a) ***Features of future contract*** The future contract has the following features:

i. *Standardized in nature* The future contracts are standardized in nature. It is characterized by few standardized specifications such as date and month of delivery, quantity, and price quotations.

ii. *Liquidity* Future contracts are highly liquid in nature, which makes it popular in the financial market.

iii. *Period of contract* The period of future contracts generally varies from 3 to 21 months.

iv. *Exchange traded* Unlike forward contracts, future contracts are standardized and exchange traded. This implies future contracts are traded on the exchange subject to the specific rules and regulations of the exchange.

v. *Presence of margin payments* The future contract is characterized by the margin requirements. Margin money should be paid by both buyers and sellers.

vi. *Limited number of contracts* The number of contracts is limited in case of future contracts. It is generally limited between 4 and 12 in a year (Table 6.1).

3. **Options**

> An option refers to a contractual agreement that ensures a right, but not the obligation, to buyer or the seller to buy (in a call option) or to sell (in a put option) a specific instrument at a per-determined price (which is known as strike price) on or before the specified date in the future.

The maker of the option is known as option writer and the holder of the option as option buyer. The holder of the options has to pay the price of the options, which is known as 'premium'. The premium is determined by the expected variance in price in future, market liquidity, rate of interest, dividend, etc.

Table 6.1 Distinction between forward and future contracts

Basis of Difference	Forward	Future
Definition	It is a derivative contract where the traders make an agreement to exchange goods for cash at a pre-determined future date and at a stipulated price agreed upon today	It refers to a standardized contract that is traded in future at exchange. It provides an assurance by the exchange authority to trade a security, good, or currency at a pre-determined date at a price agreed upon today
Nature of transactions	They are OTC contracts	They are exchange traded
Delivery	Generally, a single delivery date	Generally, a range of delivery dates
Liquidity	No liquidity	Highly liquid
Credit risk	They involve credit risk	They do not involve credit risk.
Margin	No margin requirements	Both buyer and trader have to pay margin money
Risk of counterparty	Exists	Non-existent
Regulation	Generally traded in an unregulated market	Financial regulators regulate the transactions
Contract price	Not disclosed publicly	Publicly disclosed
Settlement of date	They are settled in the maturity date	They can be settled on or before maturity date
Profit or loss	It is realized when the contract matures	It is realized on daily basis

It should be noted that, if the option buyer does not exercise the option, then he/she will only lose the amount of premium.

a) ***Features of option*** The option is an important derivative technique practiced all over the world including India. The salient features of the options are:

   i. *Transaction right* The options provide the opportunities to buy and sell some underlying assets such as securities, currencies, and commodities. It is only exercisable by the option holder.

   ii. *No obligation* Though the option holder has the right to buy or sell the underlying assets such as securities, commodities, and currencies, there is complete absence of obligation. In case of huge losses, the holder will not exercise the option and, instead, only pay the premium prices.

   iii. *Strike price/exercise price*

   > The price at which the transactions of underlying assets have been performed is known as the strike price. It is also known as the 'exercise price'.

   iv. *Time limit* European option can be exercised only on the date of maturity. However, American option can be exercised any time prior to the maturity date or in the maturity date.

   v. *Types of options* The options are of two types call options and put options. In case of call options, the holder has the right to purchase the assets if market price is greater than strike price. Conversely, in case of put option, the holder has the right to sell the assets if market price falls below the strike price.

   vi. *Difference from shareholder* An option holder and share holder is completely different from each other in terms of various rights. The shareholders enjoy voting rights, dividends, etc. An option holder has no such rights.

b) ***Types of option*** As we have mentioned earlier, options are of two types call option and put option.

   i. *Call option* Call options offer the right (not obligation) to the investor or option holder, to purchase the underlying assets such as commodity, currency, or securities by a specified date or before at a certain price. If the option holder exercises his right, then the seller has the obligation to fulfil the contract. An investor opts for call if he/she expects that market price will go above the strike price.

We can explain the process of call option through the following *example*. Let the listing price of the share X in the share market be ₹ 100. The premium price per share is determined at ₹ 20. Let an investor or the option holder purchase a call option to buy 100 shares at ₹ 250 after 3 months. Now, let the spot/market price becomes ₹ 350 after 3 months. Here, the option holder will definitely exercise his right by paying ₹ 25,000 to the seller. Here, his/her net gain will be [(spot/market price - strike price) - premium price] × no of shares, that is ₹ [(350 − 250) − 20] × 100 = ₹ 8000. However, if after 3 months, the market price of X falls to ₹ 75, then naturally, the option holder will not exercise his/her option to avoid the possible loss, as he/she has no obligation. In that case, he/she has to pay only the premium price, that is ₹ 20 × 100 = ₹ 2000. Thus, his/her maximum loss will be the premium price.

ii. *Put option* Put option offers the right (not obligation) to the investor or option holder to sell the underlying assets such as currency, commodity, and securities by a certain date at a pre-determined price. If the option holder exercises his right, then the buyer has the obligation to fulfil the contract. An investor opts for put if he/she expects that spot or market price will fall below the strike price.

We can illustrate this fact through the following example. Let the listing price of the share Y in the share market is ₹ 100. The premium price per share is determined at ₹ 20. Let an investor or the option holder purchases a put option to sell 100 shares at ₹ 250 after 3 months. Now, let the spot/market price becomes ₹ 150 after 3 months. Here, the option holder will definitely exercise his right and sell these 100 shares for ₹ 250. Here, his/her net gain will be [(strike price - spot/market price) - premium price] × no of shares, that is ₹ [(250 − 150) − 20] × 100 = ₹ 8000. However, if after 3 months, the market price of share of company Y rises to ₹ 350, then naturally the option holder will not exercise his/her option to avoid the possible loss, as he/she has no obligation. In that case, he/she has to pay only the premium price, that is ₹ 20 × 100 = ₹ 2000. Thus, his/her maximum loss will be the premium price (Tables 6.2 and 6.3).

4. **Swaps**

Swaps are defined as the customized contracts between two parties to exchange cash flow in the future on the basis of a pre-determined formula. It is a type of financial instrument concerned with exchange mechanism.

Table 6.2 Distinctions between call option and put option

Basis of Difference	Call Option	Put Option
Definition	Call options offer the right (not obligation) to the investor or option holder, to purchase the underlying assets such as commodity, currency, or securities by a specified date or before at a certain price.	Put option offers the right (not obligation) to the investor or option holder to sell the underlying assets such as currency, commodity, and securities by a certain date at a pre-determined price
Value	Rises if value of underlying asset rises	Decreases if value of underlying asset rises
Risk	Buyer's risk is restricted, but seller's risk is unlimited	Buyer's risk is unlimited, but seller's risk is restricted
Right and obligation	Provides a right to buy an underlying asset	Provides an obligation to sell an underlying asset
Outlook	The option holder remains optimistic in nature	The trader remains pessimistic in nature
Link with stock market	Direct relationship with stock market	Inverse relationship with stock market

Table 6.3 Distinction between future and options

Basis of Difference	Option	Future
Definition	An option is a contractual agreement that ensures a right but not the obligation, buyer or the seller to buy or to sell a specific instrument at a pre-determined price (which is known as strike price) on or before the specified date in the future	It refers to a standardized contract that is traded in future at exchange. It provides an assurance by the exchange authority to trade a security, good, or currency at a pre-determined date at a price agreed upon today
Nature of transactions	Only the seller is required to execute the contract	Both buyers and sellers are required to execute the contract
Maturity period	Shorter period of maturity	Longer maturity period
Margin	Only the seller has to pay the margin money	Both buyer and trader have to pay margin money
Users	Small traders with low risk	Traders with high risk
Policy	Option holder can avoid trading if transaction is not profitable	Transaction in stipulated date is mandatory

Swap technique is used in the conditions of changing rate of interest, undulating fluctuations in the foreign exchange rate, etc.

According to the financial experts, swaps are of three types:

a) ***Currency swaps*** To minimize the risk associated with volatility of the currency rates, these types of swaps are used. It refers to the agreement where the currencies are exchanged at a certain exchange rate. In other words, a currency swap or a cross-country swap refers to a foreign exchange derivative between two institutions to exchange the principal and/or interest payments of a loan in one currency for equivalent amounts, in terms of net present value, in another currency (Wikipedia).

b) ***Interest rate swaps (IRS)*** These indicate the arrangements interlinked to only the interest related cash flows between the different parties in the same currency. IRS implies a liquid financial derivative instrument in which the two parties involved agree to exchange interest rate cash flows. This technique is used for both speculation and hedging.

c) ***Debt-equity swaps*** This refers to purchasing of a debt of a less-developed nation at a discount to acquire the equities of that nation. This type of swap transaction enables a borrower to transform the loans into equity.

Apart from these above-mentioned derivative techniques, some notable techniques are warrants, baskets, Long-term Equity Anticipation Securities (LEAPS), etc.

6.4 REGULATORS OF INDIAN FINANCIAL MARKET

Financial system is the base of economic development. Hence, it is extremely important to review and evaluate the performance of the financial system. If there is any disparity between the actual performance and targeted objective, then corrective measures are taken. In this context, regulation is very important. Financial regulators take the responsibility of protecting the interest of the investors and maintaining financial discipline in the financial market.

In recent times, Indian financial system is pretty organized, and it is regulated by some well-defined rules and laws. Thus, we observe the following financial regulators in the financial market of India.

6.4.1 Central Government

Central government and Ministry of Finance regulate the financial market so that the protection of the investors as well as the financial discipline of the market is ensured. After the independence, the central government opted for various steps to strengthen the financial market and tried to remove the different loopholes of the Indian money and capital markets. The main focus was on the protection of investors' investment. Accordingly Capital Issue (Contract) Act, 1947; ESI Act, 1948; Banking Companies Act, 1949; Provident Fund Act and Rules, 1952; Companies Act, 1956; Securities Contract (Regulation Act), 1956; Life Insurance Corporation Act, 1956; SEBI Act, 1992; and IRDA Act, 1997, were passed. All these acts were passed to regulate the financial marker properly.

According to Company Act, central government has the power to covert loans into shares in public interest. Hence, the loans provided by LICI, IDBI, IFCI, NIDC, ICICI, etc. can be converted into shares in public interest.

Apart from this, the Ministry of Finance along with RBI have adopted various regulatory measures in the plan period. These measures were adopted to ensure the discipline of the financial market. Ministry of Finance have a close look on the activities of the capital and money markets. In accordance with this, ministry of finance takes regulatory measures to remove the problems of the money and capital markets.

6.4.2 Reserve Bank of India

RBI is the apex financial institution in the money market. Though RBI was established in 1935, it was not able to exercise its power over the commercial banks. In 1949, when Banking Company Act was passed, RBI gained enormous power. It gained the power of controlling all the commercial banks in the financial system. To regulate the commercial banks in the system, RBI imposed various quantitative and qualitative control measures in the system. The important quantitative control measures adopted by RBI are bank rate, open market operations, variable reserve ratio (i.e., cash-reserve ratio), and statutory liquidity ratio. The qualitative control measure implies the selective credit control measures. In fact, since bank nationalization in 1969, the regulating power of RBI in money market has increased significantly. RBI also has the power to control the authorized financial institutions.

6.4.3 Company Law Board

In Indian stock market, the existing shares of the companies are traded. Now companies are governed through Company Act. Thus, Company Act has a close relationship with the share market. The Company Act of 1956 was amended in 1963. In this amendment, it was mentioned that central government will construct a separate board for regulation of companies whose name will be Board of Company Law Administration or Company Law Board. Company Law Board was established in 1964. The basic objective of the board was to ensure transparency in the company management. The board also tries to make the company management free from corruption. As per New Companies Act, 2013, Company Law Board is replaced by NCLT.

6.4.4 Security and Exchange Board of India (SEBI)

To remove the disturbances in the share market, the central government cancelled the Capital Issue (contract) Act, 1947, in 1992. Gradually, SEBI became the principal regulatory institution of the capital market. All the members and subsidiaries in the share market have to be registered under SEBI, and accordingly, they have to obey the rules and regulations imposed by SEBI.

The capital market provides long-term finance to the industries. Hence, if the capital market is ill-managed and not free from corruption, then this leads to an adverse effect on the economy. SEBI prevents the corruptions in the capital market and, thus, strengthens the financial base of the nation. At the same time, SEBI introduces code of conduct for the subsidiaries so that it can impose control over them.

6.4.5 Insurance Regulatory Development Authority

After the adoption of new economic policy in 1991, Government of India appointed Malhotra Committee to undertake various reform measures in the insurance sector. According to the recommendations of Malhotra Committee, Government of India focused on the regulation of insurance business and consequently introduced IRDA Act. This act has the multiple objectives of regulation of insurer, settlement of disputes between insurer and insured, integrated development of insurance sector, etc. Thus, IRDA was formed in 1999.

IRDA ensures improved insurance service and protects the interest of the investors. It has the power to renew the registration and impose penal actions against the insurance companies if necessary. IRDA also has the power to regulate the nature of the insurance companies. Thus, IRDA is empowered to impose various regulatory measures in Indian insurance sector.

SUMMARY

- Financial market refers to a centre that provides the facilities of sale and purchase of financial claims and services. The individuals, financial institutions, corporations, and government trade in this market either directly or indirectly through brokers and dealers.
- Indian financial market is classified into money market, capital market, foreign exchange market, and derivative market.
- Money market is divided into organized and unorganized markets.
- Indian money market comprises call money market, certificate of deposit market, and commercial paper market.
- The capital market is classified into equity market and debt market. Equity market is divided into primary and secondary markets.
- In the foreign exchange market, currency of one nation is exchanged for the currency of another nation. Foreign exchange market facilitates international transactions, increases liquidity, and transparency.
- Derivatives are defined as written contracts between two different parties, which have no intrinsic value of its own, but it is derived from the underlying assets such as currencies, commodities, and gold. The derivatives reduce market risk and involve low transaction cost.
- In India, forward, future, options, and swaps are the main variations of the derivative.
- The derivative contract where a buyer and a seller are agreed to exchange a commodity or instrument for cash at a pre-determined price at a pre-determined date, agreed upon today, is known as forward contract. It is OTC traded.
- A future contract is often termed as a special type of the forward contract, which is standardized in nature and exchange traded.
- An option refers to a contractual agreement that ensures a right, but not the obligation, to buyer or the seller to buy (in a call option) or to sell (in a put option) a specific instrument at a per-determined price (which is known as strike price) on or before the specified date in the future. The maker of the option is known as option writer and the holder of the option as option buyer. Options are of two types call option and put option.
- Swaps are defined as the customized contracts between two parties to exchange cash flow in the future on the basis of a pre-determined formula.
- The regulators in the Indian financial market are central government, RBI, SEBI, IRDA, and company law board.

GLOSSARY

Call options offer the right (not obligation) to the investor or option holder, to purchase the underlying assets such as commodity, currency, or securities by a specified date or before at a certain price.

Call money market is the part of the money market where day-to-day transactions of surplus funds occur. This market provides short-term funds, and the time of repayment varies from 1 to 14 days.

Certificate of deposit market is the market that deals with certificate of deposits. Certificate of deposits, which are issued by the commercial banks and development financial institutions in bearer forms, refer to the short-term and unsecured negotiable instruments.

Commercial bill market is the market in which we observe the transactions of commercial bills.

Commercial paper market deals with the commercial paper, which is negotiable in nature, and implies a short-term promissory note issued by the big and highly rated companies.

Derivative market is the place of interaction between risk-averse people and risk-lovers through derivatives.
Equity market refers to that part of capital market that deals with shares and debentures of various joint stock companies.
Foreign exchange market refers to a market in which domestic currency or claims are exchanged for foreign currencies.
Forward contract is the derivative contract where a buyer and a seller are agreed to exchange a commodity or instrument for cash at a pre-determined price at a pre-determined date, agreed upon today.
Future contract refers to a standardized contract between two parties to purchase or sell an asset at a specified time in future for a certain price agreed by the parties involved.
Option refers to a contractual agreement that ensures a right, but not the obligation, to buyer or the seller to buy (in a call option) or to sell (in a put option) a specific instrument at a per-determined price (which is known as strike price) on or before the specified date in the future.
Primary or new issue market is the financial market that deals with new financial claims or securities. As this part of financial market deals with new securities, it is known as 'new issue market'.
Put options offer the right (not obligation) to the investor or option holder to sell the underlying assets such as currency, commodity, and securities by a certain date at a pre-determined price.
Repo or repurchase agreement is the transaction in which a financial institution or a bank receives funds immediately by selling securities with an agreement to repurchase the same at a specified pre-determined price after a specific time period.
Reverse repo in this, a financial institution or a bank purchases a security with an agreement to sell it back on a specific date at a pre-determined price.
Secondary market is the part of the financial market that deals with the already existing or new securities. Thus, in the secondary market, existing securities are sold and purchased. Secondary market is also known as 'stock market'.
Swaps are defined as the customized contracts between two parties to exchange cash flow in the future on the basis of a pre-determined formula. It is a type of financial instrument concerned with exchange mechanism.
Treasury bill market is the market in which the transactions of the treasury bills occur. Treasury bill refers to a commercial bill or a financial instrument issued by the central bank on behalf of the government in order to meet the short-term liquidity problem. The market in which the transactions of the treasury bills occur is known as treasury bill market.

MULTIPLE CHOICE QUESTIONS

1. In the call money market, time repayment varies from
   (a) 1–365 days (b) 1–14 days
   (c) 1–21 days (d) 1–164 days
2. Commercial bills
   (a) Increases the size of goods market
   (b) Provides liquidity
   (c) Expands credit facilities
   (d) All of the above
3. The treasury bills are issued by
   (a) Reserve bank of India
   (b) Commercial banks
   (c) Merchant banks
   (d) Development banks
4. Which is not a type of treasury bills?
   (a) 15 days (b) 91 days
   (c) 182 days (d) 364 days
5. Certificate of deposit was introduced on India in
   (a) 1991 (b) 1990
   (c) 1989 (d) 1988
6. New issue market refers to
   (a) Commodity market (b) Primary market
   (c) Secondary market (d) Stock market
7. Which of the following is not a feature of the derivatives?
   (a) It increases the market risk
   (b) It predicts the market movements
   (c) It raises liquidity
   (d) It reduces the transaction costs
8. The period of future contract generally varies from
   (a) 1–14 days (b) 3–21 days
   (c) 3–21 months (d) 1–2 years
9. Strike price in case of option is also known as
   (a) Shadow price (b) Equilibrium price
   (c) Exercise price (d) Premium price
10. Which of the following cannot be regarded as a type of swap?
    (a) Currency swaps (b) Warrant swaps
    (c) Interest rate swaps (d) Warrant swaps
11. Forward contract involves
    (a) Generally a single delivery date
    (b) Liquidity
    (c) No credit risk
    (d) Margin requirements
12. Which of the following is not a feature of the future contract?
    (a) They are exchange traded
    (b) Highly liquid
    (c) They involve credit risk
    (d) Buyers and sellers have to pay margin money

13. Which of the following is not a feature of put option?
    (a) Buyer's risk is unlimited but the seller's risk is restricted
    (b) Provides an obligation to sell an underlying asset
    (c) The trader remains pessimistic in nature
    (d) Direct relationship with stock market

14. RBI was established in
    (a) 1935 (b) 1940
    (c) 1937 (d) 1952

15. IRDA was formed in
    (a) 1998 (b) 1999
    (c) 2000 (d) 2001

EXERCISES

1. What do you mean by financial markets?
2. Define financial market. Mention its role and significance.
3. What is an equity market? What are its divisions?
4. Define derivatives. What are the features of a derivative?
5. Define foreign exchange market. How does the foreign exchange market assist in the international transactions?
6. Define forward contract. What are the features of a forward contract?
7. What do you mean by future contract? Discuss the features of the same.
8. Distinguish between forward and future contracts.
9. What are options? How do the options ensure profit for the option holder?
10. What are the types of options? Discuss the features of the different types of options.
11. Distinguish between call options and put options.
12. Distinguish between options and futures.
13. Discuss the uses and trading mechanism of forward contract.
14. Define swaps. What are its types? Discuss the features of swap.