# Meaning, Functions & Classification of Financial Market

## 1 Mark Questions

**1. State any one consequence of a well performed allocative function of financial market.(Delhi 2013)**

**Ans**. Providing liquidity to financial assets.

**2. Name the two major alternative mechanisms through which allocation of funds can be done. (All India 2013)**

**Ans**. (i) Banks
(ii) Financial markets

**3. Give the meaning of secondary market. (Delhi 2013)**

**Ans.** Secondary market refers to market for sale and purchase of previously issued securities. It is also known as stock exchange.

**4. Give the meaning of money-market. (Delhi 2013)**

**Ans**. Money-market refers to market for short-term funds, which deals in monetary assets whose period of maturity is upto one year.

**5. State the essential function of primary market. (All India 2013)**

**Ans.** The important function of a primary market is to facilitate the transfer of investible funds from savers to entrepreneurs, seeking to establish new enterprises.

**6. What is meant by capital market? (Delhi 2011c)**

**Ans.** Capital market refers to whole network of organisations, institutions through which medium and long-term funds, both debt and equity are raised and invested.

**7. What is meant by 'primary market'? (All India 2011)**

**Ans.** Primary market is the market where securities are being issued for the first time. Therefore, it is also known as 'New Issue Market' (NIM).

## 3 Marks Questions

**8. Give the meaning of the following money market instruments**
**(i) Certificate of deposit; and**
**(ii) Commercial bill (Compartment 2014; Foreign 2014)**

**Ans**. (i) C**ertificate of deposit** These are short-term, unsecured, negotiable instruments in bearer form. They are issued by commercial banks or development financial institution to individuals, corporations and companies. These are issued generally in times of tight liquidity when the deposit growth of banks is slow but the demand for credit is high, to mobilise large amounts of money for short periods.

(ii) **Commercial bill** A commercial bill is a bill of exchange used to finance the working capital requirements of business firms. It is a short-term negotiable, self-liquidating instrument, whijch is used to finance the credit sale of the firms. When goods are sold on credit, seller draws the bill of exchange on the buyer. On being accepted by the buyer, it becomes a trade bill, which is a marketable instrument. On being discounted from the bank, the trade bill becomes the commercial bill.

**9.Give the meaning of the following money market instruments**
**(i)Treasury bill; and**
**(ii)Call money (Compartment 2014; Foreign 2014)**

**Ans.** (i) **Treasury bill** Also known as zero coupon bond, an T-Bill is issued by RBI on behalf of Central Government to meet its short-term requirement of funds It is issued in form of promissory note.
They are highly liquid and have negligible risk. They are issued at discount and redeemed at par, e.g. 91 days, treasury bill of face value of? 1,00,000 is purchased at ? 96,000 and at the maturity investor gets? 1,00,000, ? 4000 being the interest received by him.

(ii) **Call money** Call money is a short-term finance repayable on demand, with a maturity of 1 to 15 days. It is used for inter bank transactions. Banks have to maintain a minimum cash balance known as Cash Reserve Ratio. RBI changes this ratio from time to time. Call money is a method by which banks borrow from each other to be able to maintain Cash Reserve Ratio. The interest paid on call money loans is called call rate, which is very volatile and changes even from hour to hour.

**10. Financial market plays an important role in the allocation of scarce resources in an economy by performing various functions. Explain any three functions of financial market. (Delhi 2014)**

**Ans.** Financial market plays an important role in the allocation of scarce resources in an economy by performing these important factions:

(i) **Mobilisation of savings and channeling them into the most productive uses** A financial market facilitates the transfer of savings from savers to investors. Thus, it will help in channelising surplus funds into the most productive uses.

(ii)**Facilitating price discovery** Interaction between supplier and investor helps to establish a price for the financial asset which is being traded in that market.

(iii) **Providing liquidity to financial assets** Financial market facilitates easy purchase and sales of financial assets. In doing so, they provide liquidity which means these assets are converted into cash whenever required.

**11. What is meant by primary market? Explain any two methods of floating new issues in the primary market. (All India 2009)**

**Ans**. Primary market is the market where securities are being issued for the first time. Therefore, it is also known as 'New Issue Market' (NIM).

Methods of floatation are as follows:
(i) **Offer through prospectus** Under this method, company issues a prospectus to inform and attract general public. In prospectus, company provides details about the purpose for which funds are being raised, past financial performance of the company, background and future prospects of company.

(ii) **e-IPOs** It is the new method of issuing securities through online system of stock exchange. In this, company has to appoint registered brokers for the purpose of accepting applications and placing orders. The issuer company has to apply for listing of its securities and the leading manager coordinates all the activities of these issues through various intermediaries.

**12. Nature of money market can be well explained with the help of its features. State any three such features of money market. (All India 2008; Delhi 2008)**

**Ans.** The features of the money market are: (Any three)
(i) **Instruments** Money market raises funds by wide variety of short-term securities such as call money, treasury bills, trade bills, commercial paper, certificate of deposit, etc.
(ii) **Duration** Money market provides funds for a period of less than one year.
(iii) **Participant** The participants in the money market are large institutional investors such as Reserve Bank of India (RBI), commercial banks, financial institutions, non-banking finance companies, state government, large corporate houses, etc.
(iv)**Investment outlay** Investment in money market entails huge sum of money as the instruments are quite expensive.
(v)**Liquidity** Money market instruments enjoy a high degree of liquidity as there is a formal arrangement for it. The Discount Finance House of India (DFHI) has been established for the specific objective of providing a ready market for money market instruments.
(vi)**Expected return** The expected rate of return of the money market is generally low as money is invested for a short duration.

**13. Nature of a capital market can be well explained with the help of its features. State any three such features of a capital market. (All India 2008)**

**Ans.** The features of a capital market are: (Any three)
(i) **Link between savings and investment opportunities** Capital market is a crucial link between saving and investment process. The capital market transfers money from savers to entrepreneurial borrowers.
(ii) **Long-term funds** Capital market is concerned with medium-term and long-term funds. Funds raised through capital market are used for long-term financial needs such as procurring plant, machinery, land, etc.
(iii) **Participants** Both individual investors and institutional investors participate in capital market.
(iv) **Instruments** The main instruments of a capital market are equity shares, preference shares, bonds and debentures.

## 4/5 Marks Questions

**14. Differentiate between capital market and money market on the basis of the following**

**(i) Meaning (ii) Liquidity**

**(iii) Safety (iv) Expected return**

**(v) Duration (Delhi 2014, Foreign 2014)**

**or**

**Differentiate between capital market and money market on the basis of the following**

**(i)Participants (ii) Instruments**

**(iii)Duration (iv) Investment outlay**

**(v) Liquidity (All India 2014 C)**

**Ans. Differences between capital market and money market are:**

| Basis | Capital market | Money market |
|---|---|---|
| **Meaning** | It refers to the whole network of organisations, institutions and instruments that deal in medium and long-term funds. | Money Market is a market for short-term funds which deals in monetary assets whose period of maturity is upto one year. |
| **Liquidity** | Only actively traded securities have ready market. | In this market, there is a formal arrangement of creating liquidity. |
| **Safety** | In this market securities of every company are bought and sold. Hence, there is more risk involved. | The transaction are made in the instruments issued by the financial institutions and financially strong companies. |
| **Expected return** | The expected returns are high as there in scope of earning capital gains and long-term prosperity is also shared by the company in form of high dividends and bonus issues. | The expected return is less due to short duration and lower risk. |
| **Duration** | Period of maturity is more than one year. | Period of maturity ranges from one day to one year. |
| **Investment outlay** | Investment outlay does not necessarily require huge investment outlay. The unit prices is low, i.e. ₹ 10, ₹ 100 and so even the trading lots are small, i.e. 5, 50, 100 etc. | Money market transactions entail huge sums of money as instruments are quite expensive. |
| **Participants** | Individual investors as well as institutional investors like financial institutions, banks, corporate houses and foreign investors participate in the capital market transactions. | The participants are RBI, Commercial Banks financial institutions, mutual funds and corporate houses. Individual investors do not participate in money market. |
| **Instruments traded** | The instruments of capital market include equity shares, preference shares, bonds, debentures, etc. | Some of the main instruments used in money market are commercial paper, treasury bills, trade bills, certificate of deposit, etc. |

**15. What is meant by capital market ? Name the two types of capital market and differentiate between the two on any four basis (Compartment 2014)**
**or**
**Difference between 'Primary Market' and 'Secondary Market' on any five basis. (Ail India 2014)**

**Ans**. Capital market refers to facilities and institutional arrangements through which long-term fund, both debt and equity are raised and invested. The capital market consists of development banks, commercial banks and stock exchanges.
The two types of capital market are
(i) Primary market or new issue market (NIM)

(ii) Secondary market or stock exchange

| Basis | Primary market | Secondary market |
|---|---|---|
| **Meaning** | It means the market where corporate sector, government and public bodies issue securities to raise funds from the public. | It means the market where listed shares, debentures and other securities are traded for investment and speculative purposes. |
| **Nature of securities dealt in** | In primary market, new securities are traded. | In secondary market, second hand securities are traded. |
| **Alternate name** | It is also known as 'new issues market'. | It is also known as 'stock exchange'. |
| **Capital formation** | It promotes capital formation directly as funds flow directly from savers to investors. | It promotes capital formation indirectly. |
| **Pricing** | Prices are determined and decided by the management of the company. | Prices are determined by demand and supply for the security. |

**16. Financial market plays an important role in the allocation of scarce resources in an economy by performing many important functions. Explain any four such functions. (Foreign 2014; All India 2011)**
**or**
**Explain any three functions of financial market. (All India 2013)**
**or**
**Explain any four functions of financial market. (Delhi 2012)**
**or**
**What is meant by financial market? Explain any two functions of financial market. (All India 2011)**
**or**
**Describe any four functions of financial market.(All India 2011)**

**Ans**. **Meaning of financial market** It is a link between the savers and the borrowers. This market transfers money or capital from those who have surplus money to those who are in need of money.
The functions of financial market are:
(i) **Facilitating price discovery** In the financial market, households are suppliers of funds and business firms represent the demand. The interaction between them helps to establish a price for the financial asset which is being traded in that particular market.
(ii)**Provides liquidity to financial assets** The investors can invest their money, wherever they desire, in securities through the medium of financial market and convert them into cash by selling their financial assets through the mechanism of financial market.
(iii)**Reduce the cost of transactions** Financial market provides complete information regarding price, availability and cost of various financial securities. So, investors and companies do not have to spend much on getting this information.
(iv) **Mobilisation of savings and channelising them into most productive uses** A financial market facilitates the transfer of savings from savers to investors. It gives

savers a wide choice of making investments and thus, channelise surplus funds into productive uses.

**17. Explain any four methods of floating new issues in the primary market. (Ail India 2012)**
**or**
**Explain any four methods of flotation of new issues in the primary market.(Delhi 2011 C)**

**Ans.** There are various methods of floating new issues in the primary market: (Any four)
(i) **Offer through prospectus** Under this method, company issues a prospectus to inform and attract general public. In prospectus, company provides details about the purpose for which funds are being raised, past financial performance of the company, background and future prospects of company.
(ii)**Offer for sale** Under this method, securities are not issued directly to the public but are offered for sale through intermediaries like issuing houses on stock brokers at a fixed price.
(iii)**Private placement** Under this method, company sells the securities to some selected institutional investors (like UTI, LIC, etc) and some individuals.
(iv) **e-IPOs** It is the new method of issuing securities through on line system of stock exchange. In this, company has to appoint registered brokers for the purpose of accepting applications and placing orders.
(v)**Right issue** This is a right (or privilege) to existing shareholders to subscribe to a new issue of shares in proportion to the number of shares held by them.

**18. What is meant by money market? Explain any two instruments used in money market. (Delhi 2011)**
**or**
**Explain any two instruments used in money market. (All India 2008)**

**Ans.** Money market is a market for short-term funds which deals in monetary assets whose period of maturity is up to one year.
The two instruments used in money market are:

(i) **Treasury bills** (T-bills) It is an instrument of short-term borrowing by the RBI on behalf of government of India, maturing in less than one year. They are also known as zero coupon bonds. They are issued in the form of promissory note. They are highly liquid and provide assured yield. There is no risk of default. They are issued at a discount and repayable at par. They are available for a minimum amount of ? 25,000 and in multiples thereof.

(ii) **Commercial paper** (CP) A commercial paper is an unsecured instrument issued in the form of a ‘ promissory note. They are negotiable and transferable by endorsement and delivery. It is issued by large and credit worthy companies for reusing short-term funds at lower rates of interest than market rates, It usually has a maturity period of 15 days to one year. It is sold at a discount and ‘ redeemed at par.

## 6 Marks Question

**19. Explain the following money market instruments (Delhi 2013)**
**(i)Call money (ii) Treasury bill**
**(iii) Commercial paper (iv) Certificate of deposit**

**Ans**. Money market refers to market for short-term funds, which deals in monetary assets whose period of maturity is upto one year.
(i) **Call money** It is a method by which commercial banks borrow from each other. It is short-term finance repayable on demand, with a maturity period of one day to fifteen days, used for inter-bank transactions.
(ii) **Treasury bill** (T-bill) It is an instrument of short-term borrowing by the RBI on behalf of government of India, maturing in less than one year. They are also known as zero coupon bonds. They are issued in the form of promissory note. They are highly liquid and provide assured yield. There is no risk of default. They are issued at a discount and repayable at par. They are available for a minimum amount of? 25,000 and in multiples thereof.
(iii) **Commercial Paper** (CP) A commercial paper is an unsecured instrument issued in the form of a promissory note. They are negotiable and transferable by endorsement and delivery. It is issued by large and credit worthy companies for reusing short-term funds at lower rates of interest than market rates. It usually has a maturity period of 15 days to one year. It is sold at a discount and redeemed at par.
(iv) **Certificate of Deposit** (CD) They are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks. Only bank can issue CD. It is a bearer certificate and is negotiable in the market.