NCERT Solutions Class 12
Business Studies
Business Finance and Marketing
Chapter 10 : Financial Markets Class 12

Multiple choice Questions

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Question 1:Primary and secondary markets

(a) Compete with each other

(b) Complement each other

(c) Function independently

(d) Control each other

Solution :

Primary and secondary markets complement each other. Primary market deals with the issue of new securities. When a company issues securities for the first time (i.e. IPO which means the first time a company is offering securities to the general public for subscription) , they are traded in the Primary Market through the help of issuing houses , Dealing /Brokerage Firms, Investment Bankers and or Underwriters. That is, through the primary market a company raises capital directly from the borrowers. On the other hand, secondary market deals in the purchase and sale of the existing securities. Stock Exchange does the work of a Secondary Market by facilitating a formal trading arrangement for financial securities. That is, once the securities are issued in primary market, they are then traded in the secondary market. It is in this sense that both the markets complement each other.

Question 2:The total number of Stock Exchange in India is

(a) 20

(b) 21

(c) 22

(d) 23

Solution :

The total number of Stock Exchange in India is 23. However, as per the latest updates by SEBI, there are 25 Stock Exchanges in India.

Question 3: The settlement cycle in NSE is

(a) T+5

(b) T+3

(c) T+2

(d) T+1

Solution :

Settlement cycle refers to the time period within which the actual settlement between the buyers and sellers of shares takes place. In other words, it refers to the time period within which the seller of the shares would receive the money and the buyers of the share would get the ownership of the share. NSE follows a T+2 settlement cycle. T+2 means the transactions done on the trade day, will be settled by exchange of money and securities on second business day (excluding Saturdays, Sundays, Bank and exchange trade holidays). Here, T refers to the transaction date. Thus, T+2 implies that transactions in NSE are settled within 2 days of the transaction date.

Question 4: The National Stock Exchange of India was recognized as stock exchange in the year

(a) 1992

(b) 1993

(c) 1994

(d) 1995

Solution :

National Stock Exchange of India was promoted by financial institutions and established as a public limited company in 1992. However, it was '*recognized as a stock exchange*' in April,'*1993*' under Securities Contracts (Regulation) Act,1956. It commenced its operations in capital market in 1994 and operations in derivatives market were started in 2000.

Question 5: NSE commenced futures trading in the year

(a) 1999

(b) 2000

(c) 2001

(d) 2002

Solution :

National Stock Exchange started its operations in the year 1994. It commenced '*trading in future'* and options market on 12 June, '*2000'*.

Question 6: Clearing and settlement operations of NSE are carried out by

(a) NSDL

(b) NSCCL

(c) SBI

(d) CDSL

Solution :

The clearing and settlement operations of NSE are carried out by NSCCL. NSCCL (National Securities Clearing Corporation Ltd.) was incorporated in august, 1995 and it commenced its clearing operations for NSE in April 1996.

Question 7: A Treasury Bill is basically:

a. An instrument to borrow short-term funds
b. An instrument to borrow long-term funds
c. An instrument of capital market
d. None of the above

Solution : Answer (a) Treasury Bills are an instrument to borrow short term funds. These are issued by RBI on behalf of the Government of India

Short answers questions

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Question 1:What are the functions of a financial market?

Solution :

A financial market refers to the market where the creation and exchange of financial assets such as shares and debentures takes place. The following are the functions of a financial market.

i) Mobilisation of Savings and Channeling them into the most Productive Uses

A financial market acts a link between the savers and the investors. It provides a platform for the transfer of savings from the households to the investors. It gives savers the choice of different investments and thus helps to channelize surplus funds into the most productive use.

ii) Facilitate Price Discovery

Similar to a commodity, the price of a financial asset is established through the forces of demand and supply for funds. Financial market provides a platform for the interaction of the demand of the funds (represented by the business firms) and the supply of funds (represented by the households). Thereby, it helps in determining the price of the asset being traded.

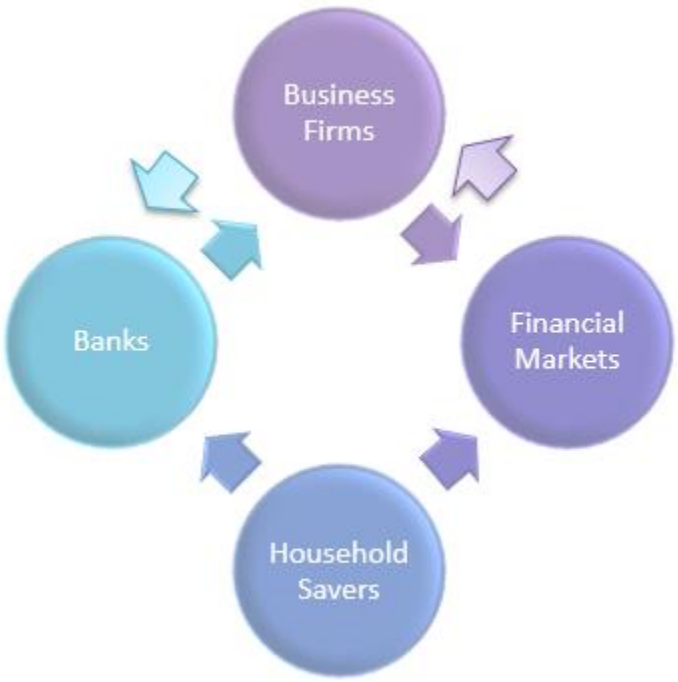
iii) Provides Liquidity to Financial Assets

An asset or a security can be easily purchased and sold in a financial market. This renders liquidity to the assets. That is, through trading in the financial market assets can be easily converted into cash or cash equivalents.

iv) Reduce the Cost of Transaction

Financial markets provide valuable information about securities being traded in the market. It helps to save time, effort and money that both buyers and sellers of a financial asset would have

to otherwise spend to try and find each other. The financial market is thus, a common platform where buyers and sellers can meet for fulfillment of their individual needs.



Question 2:''Money Market is essentially a Market for short term funds''. Discuss.

Solution :

Money market refers to the market for trading of short term securities and funds. Securities traded in the money market have a very short maturity period ranging from one day to one year. Such assets act as a close substitute for cash or money. Due to their short maturity period they are also known as 'Near Money instruments'. Money market instruments act as an important source of finance for working capital requirements. They enjoy a high degree of liquidity. DFHI discounts money market securities and offers a ready market for them. In addition, securities traded in the money market are safe and secure as the transactions are made in those instruments that are issued by financial institutions and those companies that are financially strong. Common instruments traded in the money market are treasury bills, commercial paper, call money, certificate of deposit, etc.

Question 3:What is a Treasury Bill?

Solution:

Treasury Bill is a short term promissory note issued by the Reserve Bank of India on behalf of the Central Government of India. They are issued to fulfil the short-term fund requirements of the Government of India. Maturity period of Treasury Bills ranges from 14 days to 364 days. Generally, these bills are brought by commercial banks, LIC, UTI, non-banking financial companies, etc. They are also called Zero-Coupon Bonds.

Treasury bills are highly liquid instruments because of the fact that the RBI is always ready to purchase these bills. Moreover, they are also considered to be the safest instrument as they are issued by the RBI. They are available for a minimum amount of Rs 25,000 and in multiples

thereof. Treasury Bills are issued at a discount i.e. they are issued at a price which is lower than the face value and are redeemed at par. Herein, the discount (the difference between the price of issue and the redemption value) is the interest received at the time of redemption.

Objective of issuing T-Bills is to fulfill the short-term money borrowing needs of the government. T-bills have an advantage over the other bills such as:

1. Zero Risk weightage associated with them. They are issued by the government and sovereign papers have zero risk assigned to them.
2. High liquidity because 91 days and 364 days are short term maturity.
3. Transparency.
4. The secondary market of T-Bills is very active so they have a higher degree of tradability.

Question 4: Distinguish between Capital Market and Money Market.

Solution :

The following points highlight the difference between Capital Market and Money Market.

Basis of Difference	Capital Market	Money Market
Time Span of Securities	Capital Market mainly deals in the trading of medium and long-term securities where in, the maturity period is more than one ye ar.	Money Market deals in the trading of short-term securities wherein, the maturity period can vary from one day to a maximum of one year.
Liquidity	Capital market securities are liquid in nature as they are tradable on stock exchanges, but are less liquid in comparison to the money market securities.	The securities traded are highly liquid in nature. DFHI discounts money market securities and offers a ready market for them.
Returns Expected	Expected returns are higher due to the possibility of capital gains in long-term and re gular dividends or bonus.	Expected returns are lower due to shorter duration.
Instruments	Instruments traded in capital market comp rise of equity shares, preference shares, debentures, bonds and other long-term securities.	Instruments traded in money market comprise of treasury bills, commercial bills, certificate of deposits and other short-term securities.
Risk	Capital market securities involve greater risk in terms of repayment of the principal amount.	Money market securities are less risky due to short time period and sound financial position of the issuers.

Question 5: What are the functions of a Stock Exchange?

Solution :

Stock Exchange refers to a market where buying and selling of the existing securities take place. The following are the main functions of a stock exchange.

(i) ***Provides Liquidity and Marketability***: Stock exchange provides a ready platform for trading of existing securities. In other words, it provides a continuous market for the sale and purchase of securities. Through stock exchange, securities can be easily converted into cash whenever required. In addition, long-term securities can be converted to medium-term and short-term through stock exchange.

(ii) ***Determination of Prices***: A stock exchange helps in establishing the price of the monetary assets that are traded in that market. It provides a platform for interaction for buyers and sellers of securities and thereby, helps in the determination of prices of the securities through the forces of demand and supply.

(iii) ***Fair and Safe Market***: As stock exchange is a legal and well regulated market. It trades within the defined and the existing legal framework. Thereby, it ensures safety and fairness in transactions.

(iv) ***Facilitates Economic Growth***: In a Stock Exchange the securities are continuously brought and sold. This continuous process of disinvestment and reinvestment helps in channelising the savings and the investments to the most productive use. This, enhances capital formation and economic growth.

(v) ***Spreading Equity Cult***: Through regulation of the issues and better trading practices, a stock exchange helps in educating the people about investment. It promotes and encourages the people to invest in ownership securities.

(vi) ***Acts as an Economic Barometer***: Through changes in the share prices, a stock exchange indicates the changes in economic conditions. For instance, a boom (or recession) is reflected in the rise (or fall) in the share prices.

(vii) ***Scope for Speculation***: It is generally believed that certain degree of speculation is necessary for better liquidity and to maintain demand and supply of securities. Stock exchange provides a reasonable and controlled scope of speculation within the provisions of law.

Question 6:
What are the objectives of the SEBI?

Solution :

Securities and Exchange Board of India (SEBI) was established for promoting an orderly and healthy growth of the securities market in India. The following points highlight the overall objectives of SEBI.

1.To regulate stock exchanges and the securities industry to promote their orderly functioning.

2. To protect the rights and interests of investors, particularly individual investors and to guide and educate them.

3. To prevent trading malpractices and achieve a balance between self regulation by the securities industry and its statutory regulation.

4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc., with a view to making them competitive and professional.

Question 7:
State the objectives of the NSE.

Solution :

National Stock Exchange of India was incorporated in the year1992. It was recognised as Stock Exchange in 1993 and started operations in 1994. It was established by leading banks, financial institutions, insurance companies and financial intermediaries. NSE was established with the following objectives.

(i) NSE aimed at setting up a single nationwide trading system for providing the trading facility in all types of securities. Such a system increases the confidence of the investors.

(ii) It ensured that all the investors over the country get an easy and equal access through an appropriate communication network. It increases the liquidity of the securities. Under the system of regional stock exchange the number of people involved in the transaction was limited. As against this, NSE incorporates transactions from investors from the entire country and thereby, increases the liquidity of the securities.

(iii) By using an electronic trading system, NSE aims at providing a fair, efficient and transparent securities market. Any person can get information regarding the trading of various securities from the local terminals of NSE. Thereby, it helps in reducing fraud in trading.

(iv) One of the objectives of NSE includes enabling shorter settlement cycles and book entry settlements.

(v) NSE aimed at meeting the international standards and benchmarks of stock exchange.

Long Answer Questions
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Question 1: Explain the various Money Market Instruments.

Solution :

Money Market refers to the market where short term funds are traded. Herein, short term funds are in the form of monetary assets having a maturity period of maximum one year. The following are some of the common money market instruments.

(i) Treasury Bill (T-Bills)

Treasury Bill refers to a promissory note used for short term borrowing by the government. They are the most commonly used money market instrument. They are auctioned and issued by the Reserve Bank of India on behalf of the Central Government. T-bills are available for a minimum of Rs 25,000 and in multiples thereof. T- Bills are issued at a price lower than their face value and at the time of redemption, the investor gets the amount equal to the face value. The difference between the value at which they are issued and the redemption value is the interest received on them. For example, if an investor purchases a 182-days treasury bill with a face value of Rs 56,000 for Rs 50,000. At the time of maturity, the investor will receive Rs 56,000. Thus, the difference of Rs 6,000 (56,000 - 50,000) is the interest receivable on the bill. T-Bills are also called Zero-Coupon Bonds. T-bills are highly liquid bonds and have assured yield and negligible risk of default.

(ii) Call Money

Call money is short term finance repayable on demand, with a maturity period of one day to fifteen days, used for inter-bank transactions. Commercial banks have to maintain a minimum cash balance known as cash reserve ratio. The Reserve Bank of India changes the cash reserve

ratio from time to time which in turn affects the amount of funds available to be given as loans by commercial banks. Call money is a method by which banks borrow from each other to be able to maintain cash reserve ratio. The interest rate paid on call money loans is known as the call rate. It is a highly volatile rate that varies from day-to-day and sometimes even from hour-to-hour. There is an inverse relationship between call rates and other short-term money market instruments such as certificates of deposit and commercial paper. That is, as the call rate rise, other instruments of money market become cheaper and their demand increases.

(iii) Commercial Paper (CPs)

Commercial paper is an unsecured short-term money market instrument. It is a negotiable and transferable promissory note with a maturity period ranging from a minimum of 15-days to a maximum of one year. They were introduced in India in 1990. CPs are mainly issued by large and creditworthy companies to raise short-term funds. Large companies view Commercial Papers as an alternative to bank borrowings and borrowings through capital market. The rate of interest payable on Commercial Papers is lower than the market rates. Generally, companies use Commercial Papers for bridge financing. That is, to raise the funds required to meet the floatation cost incurred on long term borrowings in the capital market. For example, if a company wishes to raise finance from the capital market to purchase land. For this, it will have to incur floatation cost such as cost related to brokerage, commission, advertising, etc. To finance such floatation costs the company can issue Commercial Paper.

(iv) Certificate of Deposit (CDs)

Certificate of Deposits are time deposits which are negotiable and unsecured in nature. They are bearer instruments for a short and specified time period ranging from one month to more than five years. CDs are a secured form of investment, which are issued to individuals, corporations and companies by the commercial banks and development financial institutions. They are issued to meet the demand for credit in times of tight liquidity position. For example, when a person buys a CD by depositing a specific amount, he receives a certificate wherein the term of deposit, the interest rate applicable and the date of maturity is written. On the date of maturity, the individual gets entitled to receive the principle amount and the earned interest on it.

(v) Commercial Bill

Commercial bill also known as bank bill or bill of exchange refers to the instrument used to finance the working capital requirements of a firm. It is a short term negotiable instrument. Companies use Commercial Bills to finance their credit sales. For example, when an individual makes credit sales, the buyer becomes liable to make the payment on a specified future date. Herein, the seller draws a bill of exchange and gives it to the buyer mentioning a specific maturity period. Once the bill is accepted by the buyer it becomes a marketable instrument which can be discounted with a bank.

Question 2:
What are the methods of floatation in Primary Market?

Solution :

The following are the various methods through which floating of new issues can be done.

(i) Offer through Prospectus

The most commonly used method for raising funds in primary market is offer through prospectus. It involves inviting the subscriptions from public by issue of prospectus. A prospectus is published as advertisements in newspapers, magazines, etc. It provides such

information as the purpose for which the fund is being raised, company's background and future prospects, its past financial performance, etc. Such information helps the public and the investors to know about the company as well as the potential risk and the earnings involved. Such issues need to be listed on one of the stock exchanges and should be in accordance with the guidelines and rules listed under the Companies Act and SEBI disclosure.

(ii) Offer through Sale

Under the offer through sale method, the company does not issue securities directly to the public rather they are issued through intermediaries such as brokers, issuing houses, etc. That is, under offer through sale, securities are issued in two steps, first the company sells its securities to the intermediaries at the face value and later the intermediaries resell the securities to the investing public .

(iii) Private Placement

Under this method, the securities are sold only to some selected individuals and big institutional investors rather than to the public. The companies either allot the securities themselves or they sell the securities to intermediaries who in turn sell them to selected clients. This method saves the company from various mandatory or non-mandatory expenses such as cost of manager fees, commission, underwriter fees, etc. Thus, the companies which cannot afford the huge expenses related to public issue often go for private placement.

(iv) Rights Issue

This is a privilege given to existing shareholders to subscribe to a new issue of shares according to the terms and conditions of the company. The shareholders are offered the ‘right’ to buy new shares in proportion to the number of shares they already possess.

(v) e-IPOs

It is system of issuing securities through online system. If a company decides to offer its securities through an online system it is required to gets into an agreement with the stock exchange. This is called Initial Public Offer (IPO). Company appoints brokers for accepting applications and placing orders. A company can apply to get listed in any stock market except from the one through which it has already offered securities.

Question 3:
Explain the recent Capital Market reforms in India.

Solution:

- The Securities and Exchange Board of India (SEBI) was established in 1988. It got a legal status in 1992. SEBI was primarily set up to regulate the activities of the merchant banks, to control the operations of mutual funds, to work as a promoter of the stock exchange activities and to act as a regulatory authority of new issue activities of companies. The SEBI was set up with the fundamental objective, "to protect the interest of investors in securities market and for matters connected therewith or incidental thereto."

  The main functions of SEBI are:-

  • To regulate the business of the stock market and other securities market.

  • To promote and regulate the self regulatory organizations

- To prohibit fraudulent and unfair trade practices in securities market.
- To promote awareness among investors and training of intermediaries about safety of market.
- To prohibit insider trading in securities market.
- To regulate huge acquisition of shares and takeover of companies.

- Establishment of Creditors Rating Agencies:

  Three creditors rating agencies viz. The Credit Rating Information Services of India Limited (CRISIL - 1988), the Investment Information and Credit Rating Agency of India Limited (ICRA - 1991) and Credit Analysis and Research Limited (CARE) were set up in order to assess the financial health of different financial institutions and agencies related to the stock market activities. It is a guide for the investors also in evaluating the risk of their investments.3) Increasing of Merchant Banking Activities Many Indian and foreign commercial banks have set up their merchant banking divisions in the last few years. These divisions provide financial services such as underwriting facilities, issue organizing, consultancy services, etc. It has proved as a helping hand to factors related to the capital market.

- Candid Performance of Indian Economy:

  In the last few years, Indian economy is growing at a good speed. It has attracted a huge inflow of Foreign Institutional Investments(FII). The massive entry of FIIs in the Indian capital market has given good appreciation for the Indian investors in recent times. Similarly, many new companies are emerging on the horizon of the Indian capital market to raise capital for their expansions.5) Rising Electronic Transactions: Due to technological development in the last few years. The physical transaction with more paper work is reduced. Now paperless transactions are increasing at a rapid rate. It saves money, time and energy of investors. Thus, it has made investing safer and hassle free encouraging more people to join the capital market.

- Growing Mutual Fund Industry:

  The growing of mutual funds in India has certainly helped the capital market to grow. Public sector banks, foreign banks, financial institutions and joint mutual funds between the Indian and foreign firms have launched many new funds. A big diversification in terms of schemes, maturity, etc. has taken place in mutual funds in India. It has given a wide choice for the common investors to enter the capital market.

- Growing Stock Exchanges:

  The numbers of various Stock Exchanges in India are increasing. Initially the BSE was the main exchange, but now after the setting up of the NSE, stock exchanges have spread across the country. Recently a new Inter-Connected Stock Exchange of India has joined the existing stock exchanges.

- Investors Protection:

  Under the preview of the SEBI the Central Government of India has set up the Investors Education and Protection Fund (IEPF) in2001. It works in educating and guiding investors. It tries to protect the interest of the small investors from frauds and malpractices in the capital market.

- Growth of Derivative Transactions:

  Since June 2000, the NSE has introduced the derivatives trading in the equities. In November 2001 it also introduced the future and options transactions. These innovative products have given variety for the investment leading to the expansion of the capital market.

- Insurance Sector Reforms:

  Indian insurance sector has also witnessed massive reforms in last few years. The Insurance Regulatory and Development Authority (IRDA) was set up in 2000. It paved the entry of the private insurance firms in India. As many insurance companies invest their money in the capital market, it has expanded.

- Commodity Trading:

  Along with the trading of ordinary securities, the trading in commodities is also recently encouraged. The Multi Commodity Exchange (MCX) is set up. The volume of such transactions is growing at a splendid rate. Apart from these reforms the setting up of Clearing Corporation of India Limited (CCIL), Venture Funds, etc., have resulted into the tremendous growth of Indian capital market.

Question 4:
Explain the objectives and functions of the SEBI.

Solution :

The Securities and Exchange Board of India was established in 1988 in order to encourage an orderly and healthy growth of the securities market. SEBI was set with an overall objective of investor protection and to promote the development and regulation of the functions of the securities market.

Objectives of SEBI:

The overall objective of SEBI is to protect the interests of investors and to promote the development of, and regulate the securities market. This may be elaborated as follows:

1. To regulate stock exchanges and the securities industry to promote their orderly functioning.
2. To protect the rights and interests of investors, particularly individual investors and to guide and educate them.

3. To prevent trading malpractices and achieve a balance between self regulation by the securities industry and its statutory regulation.

4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc., with a view to making them competitive and professional.

Functions of SEBI:

Keeping in mind the emerging nature of the securities market in India, SEBI was entrusted with the twin task of both regulation and development of the securities market.

Regulatory Functions:

1. Registration of brokers and subbrokers and other players in the market.

2. Registration of collective investment schemes and Mutual Funds.

3. Regulation of Stock Bankers and portfolio exchanges, and merchant bankers.

4. Prohibition of fraudulent and unfair trade practices.

5. Controlling insider trading and takeover bids and imposing penalties for such practices.

6. Calling for information by undertaking inspection, conducting enquiries and audits of stock exchanges and intermediaries.

7. Levying fee or other charges for carrying out the purposes of the Act.

8. Performing and exercising such power under Securities Contracts (Regulation) Act 1956, as may be delegated by the Government of India.

Development Functions:

1. Investor education

2. Training of intermediaries

3. Promotion of fair practices and code of conduct of all SRO's.

4. Conducting research and publishing information useful to all market participants.

Question 5:

Explain the various segments of the NSE.

Solution :

The National Stock Exchange is the technology driven stock exchange which was incorporated in 1992. It was recognised as a stock exchange in 1993 and started operations in the year 1994. NSE provides trading in two main segments namely, Whole Sale Debt Market Segment and Capital Market Segment.

(i) Whole Sale Debt Market Segment

This segment provides a platform for trading in fixed income securities such as state development loans, bonds issued by public sector undertaking, corporate debentures, commercial paper, mutual funds, central government securities, zero coupon bonds, treasury bills, etc. NSE started operations in Whole Sale Debt Market in June 1994. It is the first fully screen based system for trading in debt market. That is, it is the first computer based trading system. Trading in the debt market involves two parties- trading members (which are the recognised brokers of NSE) and the participants (i.e. the buyers and sellers of securities). The transactions among the participants are settled through members. For instance, the members place an order for the seller of a security which is then suitably matched by another member for buyer of a security wishing to purchase that security. An order remains in the system until it is suitably matched. This segment of NSE is also known as NEAT (National Exchange for Automated trading).

(ii) Capital Market Segment

Under this segment, NSE deals with trading in equity shares, preference shares, debentures, exchange traded funds as well as retail Government securities. It provides an efficient and transparent platform for a fair trading system. The capital market segment commenced its working in November 1995. The trading system of NSE Capital Market segment is also known as the National Exchange for Automated Trading - Capital Market (NEAT- CM). The trading operations of the Capital Market segment remain the same as in the Whole Sale Debt market system.