

Class: FY BSc

Subject : Financial Markets

Subject Code: PUSOE108

Chapter: Unit 1

Chapter Name: Introduction to Financial Markets & Functions of Financial Markets

Today's Agenda

1. Introduction to financial markets
2. About financial markets
3. Evolution of financial markets
4. Functions of financial markets in the economy
5. Additional: Case Study of First Republic Bank

1 Introduction to financial markets



What do you understand by financial markets?



What are the types of financial markets you know about, or you have come across?



Have any of you ever transacted across any financial markets?

2 About financial markets



What are financial markets?

Financial markets include any place or system that provides buyers and sellers the means to trade financial instruments, including bonds, equities, various international currencies and derivatives. Financial markets facilitate the interaction between those who need capital and with those who have capital to invest.

Financial markets rely heavily on informational transparency to ensure that the markets set prices that are efficient and appropriate. The key participants of the financial markets include investors, issuers, intermediaries and regulators.

Do you know?

Which are the two stock exchanges in India?

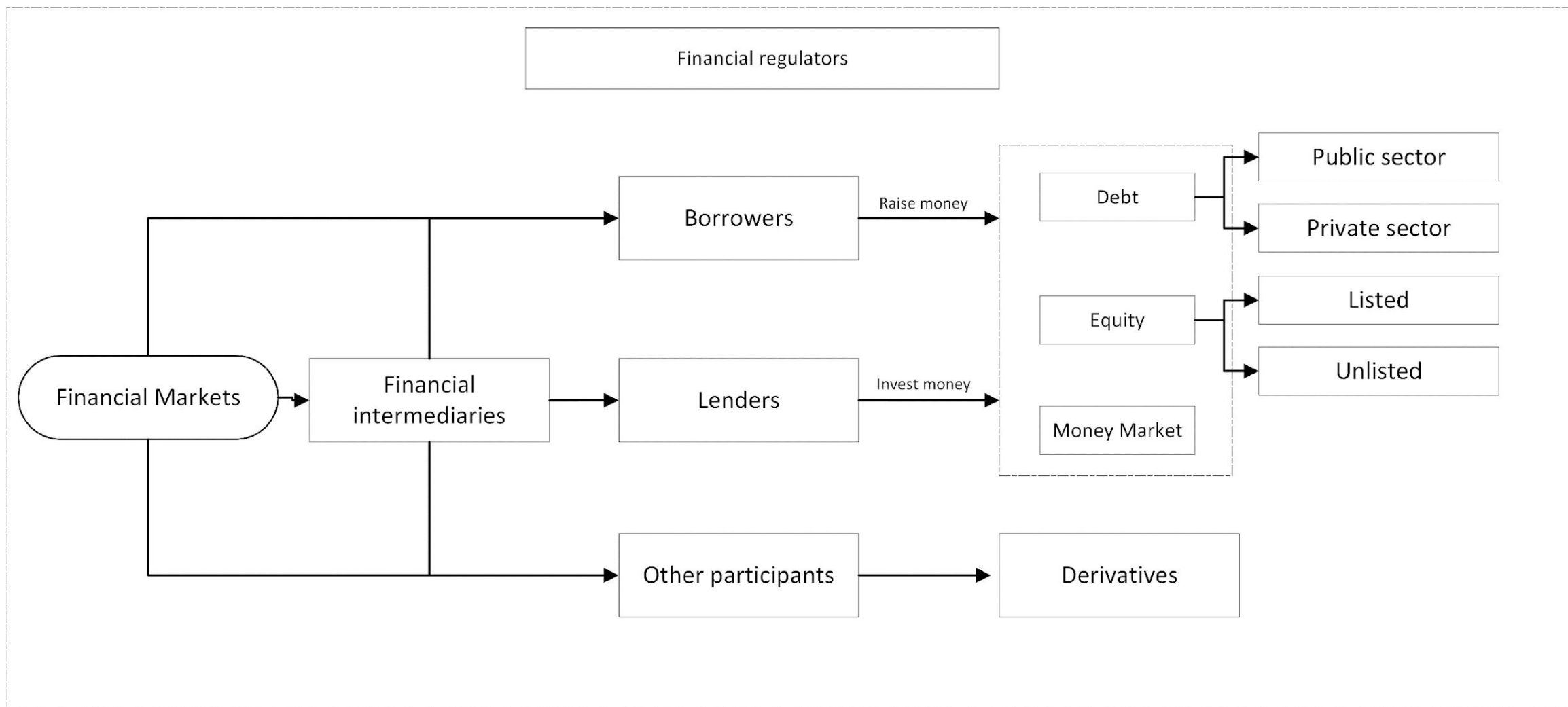


2 About financial markets

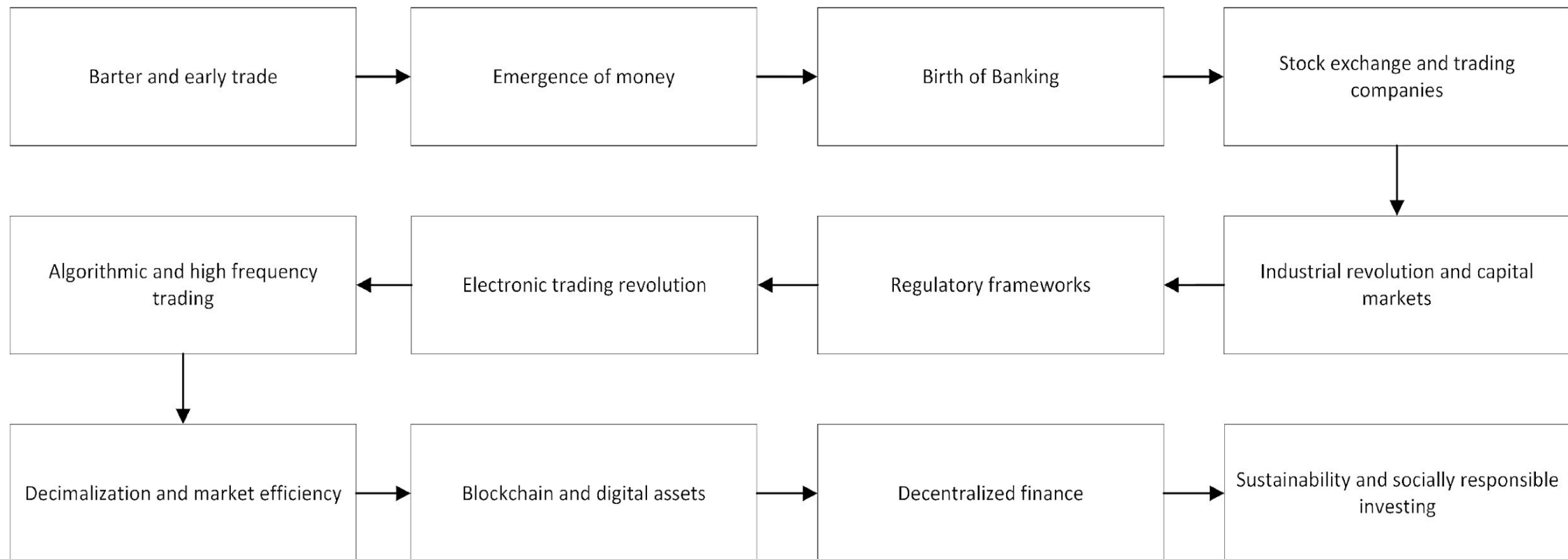
Role of financial markets in the economy

- Financial markets make it easy for investors to buy and sell assets like stocks, bonds, and derivatives, ensuring efficient capital allocation. They're a vital source of funding for businesses, supporting their growth.
- Governments also use these markets to raise funds for public projects and manage debt
- Financial markets help manage risk by offering ways to protect against price changes.
- They facilitate the smooth transfer of savings to investors, fueling economic growth.
- Pricing information in these markets helps investors make informed decisions.
- During crises, financial markets provide liquidity, promoting economic stability.
- Investors can diversify their portfolios in these markets, reducing risks associated with single assets.

2 About financial markets



3 Evolution of financial markets - History



3 Evolution of financial markets - History

Barter and early trade

In ancient times, people engaged in barter systems, exchanging goods and services directly. As societies grew, the limitations of barter systems became apparent, leading to the development of primitive forms of currency.

Emergence of money

The transition from barter to money involved the use of commodities like shells, salt, and precious metals as a medium of exchange. Eventually, precious metals, particularly gold and silver, became widely accepted as forms of currency.

Birth of banking

Wealthy people in Rome stored their coins and jewels in the basements of temples. They were seen to be secure, given the presence of priests and temple workers, not to mention armed guards. Coins could be exchanged and hoarded more easily than other commodities, such as 300-pound pigs, so a class of wealthy merchants took to lending coins, with interest, to people in need of them. Temples typically handled large loans, including those to various sovereigns, while wealthy merchant money lenders handled the rest.

3 Evolution of financial markets - History

Stock exchanges and trading companies

The 17th century witnessed the creation of formal stock exchanges, such as the Amsterdam Stock Exchange. Trading companies, like the Dutch East India Company, issued shares, allowing investors to buy and sell ownership stakes.

Industrial revolution and capital markets

The Industrial Revolution in the 18th and 19th centuries brought about significant economic changes. Capital markets expanded as companies sought financing for industrial projects, leading to the issuance of stocks and bonds.

Regulatory frameworks

The 20th century saw the establishment of regulatory bodies to oversee financial markets and protect investors. Examples include the U.S. Securities and Exchange Commission (SEC) and the Financial Services Authority (FSA) in the United Kingdom. Who is the regulator responsible for regulating stock markets in India?

3 Evolution of financial markets - History

Electronic trading revolution

The latter half of the 20th century saw the rise of electronic trading, marking a shift from open outcry systems to computerized platforms. This transition increased efficiency, reducing trading times and errors associated with manual processes.

Algorithmic and high frequency trading

Advancements in algorithms and high-speed data connections led to the rise of automated trading strategies. Traders began using computer algorithms to execute orders automatically, contributing to market liquidity.

Decimalization and market efficiency

Switching from fractions to decimal pricing in the early 2000s increased transparency and market efficiency. This move benefited investors by narrowing bid-ask spreads and improving price accuracy.

3 Evolution of financial markets - History

Blockchain and digital assets

The advent of blockchain technology introduced decentralized ledgers, giving rise to cryptocurrencies and challenging traditional financial structures. Blockchain's tamper-resistant nature provided a new level of security and transparency.

Decentralized finance

The concept of DeFi, built on blockchain, represents a recent development challenging traditional financial intermediaries. Decentralized exchanges and lending platforms are examples of DeFi applications reshaping the financial landscape.

Sustainability and socially responsible investing

Recent years have seen a growing emphasis on sustainable finance and socially responsible investing. Investors are increasingly considering environmental, social, and governance (ESG) factors in their decision-making, reflecting a broader shift toward ethical investing.

3 Evolution of financial markets – Settlement Delay

What is T + Day Settlement – T+1, T+2 and T+3

When you buy or sell a stock/bond/ or any other security, there are two critical aspects to it: one is the transaction date i.e T, and the second is the settlement date. Therefore, the abbreviations T+1, T+2, and T+3 refer to the settlement cycle dates of security transactions that happen on a transaction date plus one Day, two days, and three days, respectively.

Why delay actual settlement day?

In earlier days, security transactions were done manually as compared to today's electronic and now we are also moving towards blockchain. Investors had to wait for the delivery of their stock/bond/securities, which was in an actual certificate form, and the payment happened only after receiving the hard copy of the certificate. Since delivery times vary and prices tend to fluctuate, market regulators had to set a cutoff period in which the overall trading transaction needs to be settled.

Why delay actual settlement day?

India is the second largest market after China to implement the T+1 settlement cycle of stocks. Most international markets like the US, Europe, etc. are still in the T+2 settlement cycle.

4 **Functions of financial markets**



Why do we need financial markets?

What functions do you think does the financial market perform and how?
List some of them

4 Functions of financial markets

There are different functions that the financial markets perform. Let's understand the important ones here:

4.1. Price Determination

- The financial market performs the function of price discovery of the different financial instruments which are traded between the buyers and the sellers on the financial market.
- The financial market provides the vehicle by which the prices are set for both financial assets which are issued newly and for the existing stock of the financial assets.



What factors do you think affects the market prices of the securities?

4 Functions of financial markets

Factors affecting market prices

There are many factors that affect the prices of securities like:

- Demand & Supply
- Interest Rates
- Credit Availability
- Government Stability
- Foreign Investment
- Company statistics



4 Functions of financial markets

4.2. Funds mobilization

- Along with the determination of the prices at which the financial instruments trade in the financial market, the required return out of the funds invested by the investor is also determined by participants in the financial market.
- To mobilize funds also refers to activities undertaken by an organization to secure new and additional financial funds or to distribute the excess funds in hand

4 Functions of financial markets

4.3. Capital formation

- Financial markets provide the channel through which the new savings of the investors flow in the country which aid in the capital formation of the country.
- In case of expansion when the company requires funds, it could either raise it in the form debt issue or it could move to markets for issuing shares, if the MoA allows so.

For example, Facebook went public in May 2012, raising \$16 billion in capital through its IPO, which put the company's value at \$104 billion.

4 Functions of financial markets

4.4. Liquidity

- The liquidity function of the financial market provides an opportunity for the investors to sell their financial instruments at its fair value prevailing in the market at any time during the working hours of the market.
- Financial markets provide transparency that help the investors to keep a check on the liquidity of the stocks they invest in.

– Trading Liquidity

Trading liquidity is a market's feature whereby an individual or firm can quickly purchase or sell an asset without causing a drastic change in the asset's price.

– Funding Liquidity

Funding liquidity is the availability of credit to finance the purchase of financial assets. It is the ability of a solvent institution to make agreed-upon payments in a timely fashion i.e. to run a smooth cycle

4 Functions of financial markets

4.5. Risk Sharing

- Financial market performs the function of risk-sharing as the person who is undertaking the investments are different from the persons who are investing their fund in those investments.
- The risk is transferred from the person who undertakes the investments to those persons who provide the funds for making those investments.
- Since there is a variety of securities that trade across the financial markets, an investor can create a well diversified portfolio to mitigate risk. For instance, to include risky (say equities), moderate (say debentures) and very less risky (say T-bills) securities in appropriate proportions in the portfolio.
- Also, as there are large number of people that invest in a particular security, the risk associated with the security is divided between the large number of people and hence it is shared.

4 Functions of financial markets

4.6. Easy Access

- The industries require the investors for raising the funds and the investors require the industries for investing its money and earning the returns from them.
- So, the financial market platform provides the potential buyer and seller easily, which helps in saving their time and money in finding the potential buyer and seller.

Easy access to what?

- To funds and counterparties
- To investment opportunities
- To variety of asset classes
- To different brokers
- To information, etc.

4 Functions of financial markets

4.7. Reduction in transaction costs and provision of information

- The trader requires various types of information while doing the transaction of buying and selling the securities. For obtaining the same, time and money is required.
- The financial market helps in providing every type of information to the traders without the requirement of spending any money by them.
- The quality and quantity of information has wonderfully improved since now data is available at the tips of the hand.
- The transaction costs have reduced as now the markets operate electronically compared to earlier forms when trading had a lot of paperwork.

4 **Additional: Case study of First Republic Bank**

Case study of First Republic Bank