

Class: FY BSc

Subject : Financial Markets

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Chapter: Unit 2 Chapter 1

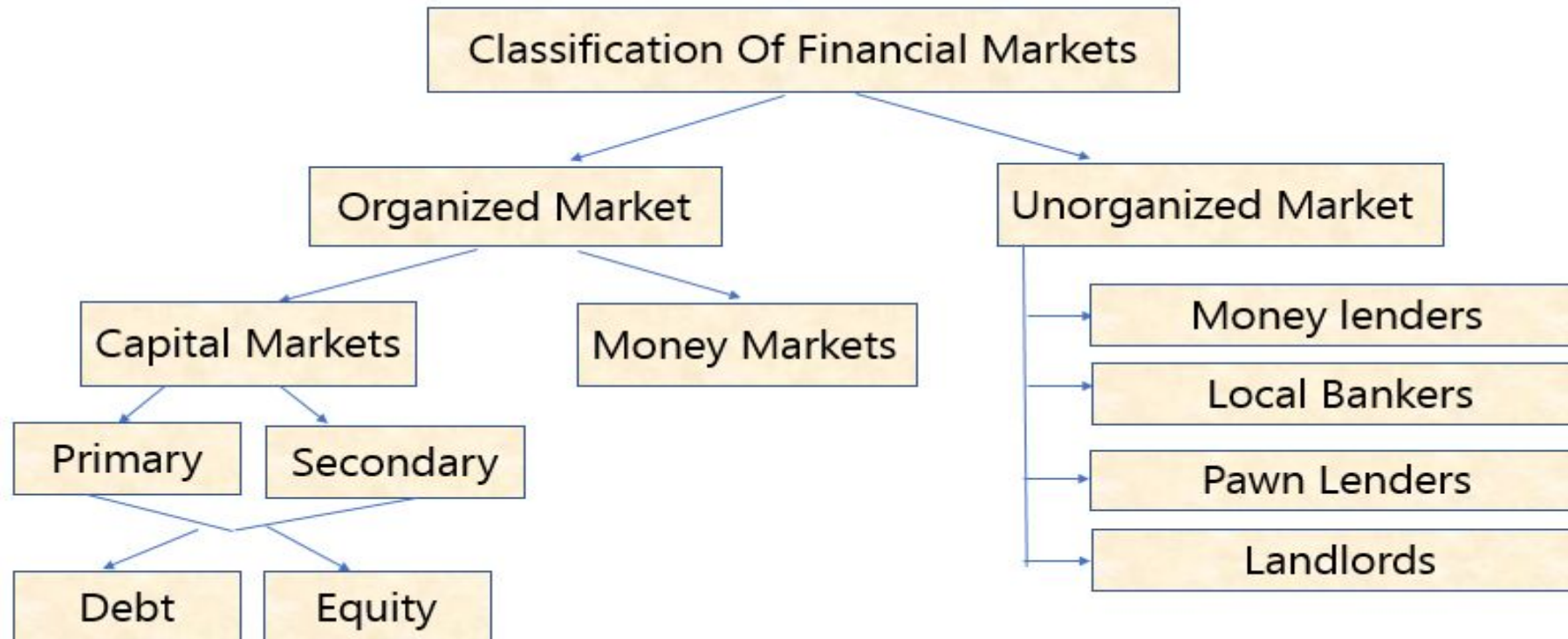
Chapter Name: Types of Markets

Today's Agenda

1. Types of Markets
2. Organized Market
3. Unorganized Financial Market
4. Primary Market
5. Secondary Market
6. Quote-Driven Market
7. Order-Driven Market
8. Brokered Market

2 Classification of Financial Market

The financial system can be classified into smaller segments, based on various-on-various grounds of classification. We understand the broader area of classification here.



2 Classification of Financial Market



On the basis of the security traded, markets can be classified into different types. What different securities and their respective markets could you think off?

2.1 Types of Markets

- The Financial Market can also be sub-divided into smaller segments on the basis of the security traded or the types of asset.
- This classification divides the entire financial market into different markets which work separately as well as with interconnection.
- The kind of asset or security traded is also different under each market.

2.2 Organized market

A formal/organized market in a specific place in which buyers and sellers meet to trade according to agreed rules and procedures. Stock exchanges, financial futures exchanges, and commodity markets are examples of organized markets.

Two types of assets mainly traded in the organized market are:

- A. Physical Assets
- B. Financial Assets



State the type of Physical and Financial assets that you know.

2.2 Organized market

2.2.A Types of Assets – Physical Assets

1. Commodities

It includes agriculture products (like wheat, corn, or coffee), metals (like gold, silver, or iron), energy products (like oil or electricity).

Some of the earliest exchanges focused on commodities, as farmers and other producers of goods sought corresponding buyers.



See the volumes and values by which commodities trade in today's time.
Read article – Commodity Trade

2.2 Organized market

2.2.A Types of Assets - Physical Assets

2. Real estate

It includes land and the fixed developments upon it.

As such, transactions tend not to occur in organized markets, but are handled by localized agents arranging specific transactions.

The value in this market is significant (mainly because the value of the underlying is very large); for homeowners, real estate is typically the largest capital investment.

2.2 Organized market

2.2.A Types of Assets – Physical Assets

3. Alternative investments

It includes art, antiques, wine, and collectibles (like rare baseball cards) are extremely illiquid and hard to value.

There are auction houses that specialize in pricing and trading these items, but the market is relatively small compared to other assets.

Example:

A handwritten letter by Albert Einstein which is rare for containing his famous $E=mc^2$ mass-energy equivalence formula has gone on sale for the sum of GBP 282,000 (approx. Rs 2,91,94,106).

The letter is dated October 26, 1946, and is one of only four known examples of the formula having been written by Einstein. According to Boston-based RR Auction, the letter, which is one-page long and blind stamped on a personal Princeton letterhead will be auctioned in a time sale which will end on May 20.

2.2 Organized market

2.2.B Types of Assets – Financial Assets

- There exist financial assets, whose value derives from some sort of contractual agreement involving future transfers of wealth.
- The three main categories of financial assets are: debt instruments, equity, and derivatives.
- Many financial assets have contracts written so that the owner of the instrument has the ability to transfer the benefits (that is, sell it) to another, in which case we call the asset a **security**.

2.2 Organized market

2.2.B Types of Assets – Financial Assets

1. Bonds and Debt instruments

These are securitized/unsecuritized loans, principally traded over the counter (OTC). While some government issues can be liquid, the majority of this market has a lower liquidity.

Many loans, however, are not securitized, and typically remain between the bank and the borrower until they are fulfilled.

Bonds have maturity dates at which point the principal amount must be paid back in full or risk default.

Example: The Sovereign Gold Bond scheme – Government securities denominated in grams of gold.

2.2 Organized market

2.2.B Types of Assets – Financial Assets

2. Equity

It includes **shares of stock**, securitized ownership in a corporation, which can range in liquidity depending upon the size of the company, many other factors.

Many shares are traded in exchanges, either physically located (like the NYSE) or electronically (like the NASDAQ). Smaller companies can be traded in the distributed OTC markets.

Private equity is also an asset, though it tends to be very illiquid



State names of equities you could think of. Example: Reliance – Ril

2.2 Organized market

2.2.B Types of Assets – Financial Assets

3. Derivatives

These are financial instruments which primarily derive their value from any other asset.

It includes financial instruments like futures contracts, options, swaps which derive value from other forms of assets.

The derivative market can be divided into two, that for exchange-traded derivatives and that for over-the-counter derivatives.



Indian Derivative Market – NSE is now world's largest derivatives exchange by number of contracts traded.

[Read Article – NSE_Derivatives_Trading](#)

2.2 Organized market

2.2.B Types of Assets – Financial Assets

4. Currency

This trading has become more significant since the largest economies removed tying their currencies directly to the value of precious metals.

Globalization, increased imports and exports, countries becoming open economies etc. are factors that contribute to immense growth of currency trading.

Given the high level of liquidity in most currencies, these markets are very competitive and active 24 hours a day due to different time zones in different countries and markets.

2.3 Unorganized Financial Market

- **Unorganized Financial System**, includes relatively less controlled moneylenders, indigenous bankers, landlords, traders etc. This part of the **financial system** is not directly amenable to control by the Reserve Bank of India (RBI).
- Amongst the features of this sector are ease of entry, smaller scale of operation, local ownership, uncertain legal status, operating using lower technology based methods, a higher proportion of migrants, etc.
- The main demand in the unorganised market comes from the agriculturists, private individuals for consumption rather than production and even small traders.
- The supply of money-capital comes, usually from own resources of money lenders and from savings and deposits of customers.

2.3 Unorganized Financial Market

2.3.A Traders in the Unorganized Markets

1. **Money Lenders** – A moneylender is a person or group who offers small Personal Loans at high rates of interest. Most of the time the borrower prefers to take Loan without any collateral
2. **Pawn Brokers** – Pawnbroker is an individual or business, that offers secured loans to people, with items of personal property used as collateral. The personal property kept as collateral can be sold if the money is not returned within a certain time.
3. **Landlords** – landlord is the owner of a house, apartment, land which is rented to an individual or business, who is called a tenant. People give their land as a collateral in order to fulfil urgent need to heavy finance. etc.

2.3 Unorganized Financial Market

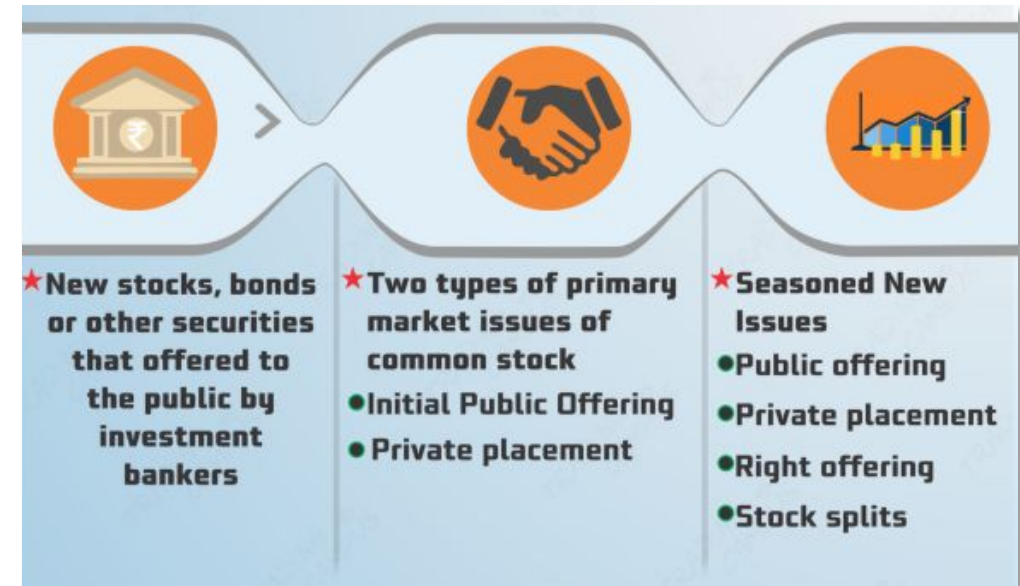


Discuss

If people can get loan through a bank at a lower rate of interest, why do you think they tend towards the unorganized market and agree to pay higher rates??

2.4 Primary Market

- A primary market issues new securities on an exchange for companies, governments, and other groups to obtain financing through debt-based or equity-based securities.
- The primary market is where securities are created. It's in this market that firms sell (float) new stocks and bonds to the public for the first time.
- The important thing to understand about the primary market is that securities are purchased directly from an issuer.



2.4 Primary Market

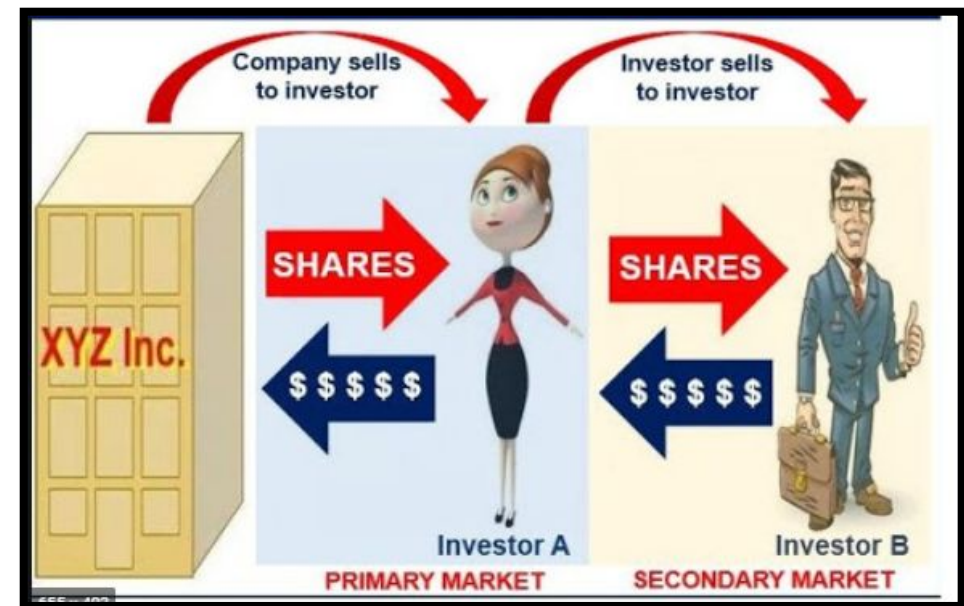
2.4.A Issues on the Primary Markets

- An initial public offering, or IPO, is an example of a primary market issue. **Example:** Innova Captab Limited, an integrated pharmaceutical company released its IPO in December 2023 with total size of Rs 570cr.
- Other types of primary market offerings for stocks include private placement and preferential allotment, qualified institutional placement etc. **Example:** Jindal Steel and Power Ltd raised Rs 1,200 cr through qualified institutional placement (QIP) in 2018.
- Similarly, businesses and governments that want to generate debt capital can choose to issue new short- and long-term bonds on the primary market. **Example:** Wockhardt plans to raise up to Rs.150 cr via Non-Convertible Debentures – dated March,2021.
- All are subject to strict regulation. Companies must file all required statements with the concerned agencies.

2.5 Secondary Market

- The secondary market is where investors buy and sell securities they already own.
- It includes the "stock market," though stocks are also sold on the primary market when they are first issued.
- Transactions termed secondary simply because they are one step removed from the transaction that originally created the securities in question.
- Though stocks are one of the most commonly traded securities, bonds, mortgages, mutual funds also have secondary markets.
- Prices in the secondary market are determined by the basic forces of supply and demand in the market.

Example



2.5 Secondary Market

2.5.A Support of the Secondary Market – Liquidity

- The Secondary Market provides liquidity to the shares you buy in the primary market.
- This gives investors the ability to liquidate his assets or transfer his risk to another investor as and when he feels the need for it.
- This liquidity helps issuers attract more demand for their security offerings in the primary markets, which leads to higher initial sale prices and thus a lower cost of capital.

2.5 Secondary Market

2.5.B Support of the Secondary Market – New Issues

- The price of a stock trading in the secondary market acts as a report card for the company. **Example**, the trading and growth in share price of Reliance over time helps the investors to analyse the working of the company and thus to make an informed decision whether to invest or not. Now since we know that RiL has performed really well on the list, it is easy for the company to raise finance as investors would be willing to buy shares.
- The price at which a company is trading in the secondary market can be used as a reference rate for raising further capital in the primary market or, their shares can be used as a means of payment for new acquisitions. **Example:** Generally IPO's are priced lower than the current price at which the share is trading.



Question

1. _____ is a link between savers & borrowers, helps to establish a link between savers & investors.
 - (a) Marketing
 - (b) Financial market
 - (c) Money market
 - (d) None of these

2. Stock exchange is known as _____ market for securities.
 - (a) Primary market
 - (b) Secondary market
 - (c) None of the above

3. Which of the following is the function of financial market?
 - (a) Mobilization of savings
 - (b) Price fixation
 - (c) Provide liquidity to financial assets
 - (d) All of the above



Question

4. When securities are allotted to institutional investors & some selected individuals is referred to as _____.

- (a) Initial public offer
- (b) Offer through prospectus
- (c) Private placement
- (d) Offer for sale

5. _____ is the organisations, institutions that provide long term funds.

- (a) Capital market
- (b) Money market
- (c) Primary market
- (d) Secondary market

2.6 Quote-Driven Market

- A quote-driven market is a system in which prices are determined from bid and ask quotations made by market makers and dealers. They are referred to as a dealer's market because each trade is executed through a dealer.
- Quote-driven markets are the most commonly used execution systems for markets such as bonds, currencies and commodities.
- In these markets trades are conducted through in-house digital communication systems, telephone or even through instant messaging.
- There are some dealers' markets where traders can trade directly with each other. However such a market is not a pure quotes-driven market. **For example**, Nasdaq Stock Market is a quotes-driven market in which even trades are brokered directly between traders.

2.6 Quote-Driven Market

2.6.A Trading in a quote-driven market

- The dealers, working with investment banks, commercial banks, and broker-dealers, provide quotes for different instruments and all customers need to trade through them at the quoted prices.
- Most trades in these markets are conducted through proprietary computer communications networks or by phone.
- Order execution is guaranteed in a quote-driven market because market makers are required to meet the bid and ask prices they quote.
- Furthermore, a quote-driven market is more liquid due to the presence of market makers, however it lacks transparency.

2.7 Order-Driven Market

An order-driven market is a financial market where all buyers and sellers display the prices at which they wish to buy or sell a particular security, as well as the amounts of the security desired to be bought or sold.

Here's an example of the working of an order-driven market.

Order Driven Market			
Buy Orders		Sell Orders	
Shares	Price	Shares	Price
134,084	42.64	59,100	42.65
477,634	42.63	184,969	42.66
387,190	42.62	195,682	42.67
190,780	42.61	372,964	42.68
250,441	42.60	300,630	42.69
252,286	42.59	162,506	42.70
526 Buy Orders		445 Sell Orders	

2.6 Order-Driven Market

2.6.A Trading in an order-driven market

- Order driven trading systems rank buy and sell orders according to price, matching the highest-ranking orders (if possible) at the minimum order amount. If there is a remaining volume of shares to be bought or sold in a given order, trading systems will match the order with the next highest-ranked sell or buy order.
- The biggest advantage of participating in an order-driven market is transparency but it may not have the same degree of liquidity as a quote-driven market.
- **For Example**, NSE is an Order Driven market.

2.7 Brokered Market

- A brokered market involves agents or intermediaries in purchase and sale transactions to facilitate price discovery and transacting the execution.
- The use of brokers as intermediaries between buyers and sellers aids market efficiency by fostering liquidity, reducing bid-ask spreads and boosting transaction volumes.



2.7 Brokered Market

2.7.A Trading in an brokered market

- Brokered markets are used for all manner of securities, especially those with initial issues.
- An IPO, for example, will usually be launched through an investment bank, who brokers the issue trying to find subscribers. This is also similar for new bond issues.
- Brokered markets are preferred for expensive and less liquid assets. Trades in this market usually take place between a small number of people or institutions

2.7 Brokered Market

The example of the forex dealer and forex broker

A bank dealer quotes a BID rate for his export base customer \$ 5 million at 76.00. In this transaction, he has bought \$5 million at 76.00. the bank dealer can immediately sell the dollars which he had purchased from his customer in the market at the same rate or if he has a view that the rate will be going up he may opt to hold the long position and sell it when the rate of the dollar increases. Thus, to earn profit by selling above the price at which he has bought from his customer.

In the case of a broker the situation is not the same, if any entity approaches him to sell the dollar he has to find a suitable counterparty for the same and he has to transact at the market rate. Thus, the broker doesn't earn in the price difference. He earns brokerage by bringing two parties.

The above example shows the dealer also has to face exchange rate risk at times when he doesn't cover the transaction at the same time as the market is volatile and can go against the direction of the dealer. Brokers do not take their own position in the market, they just bring two parties together to transact.