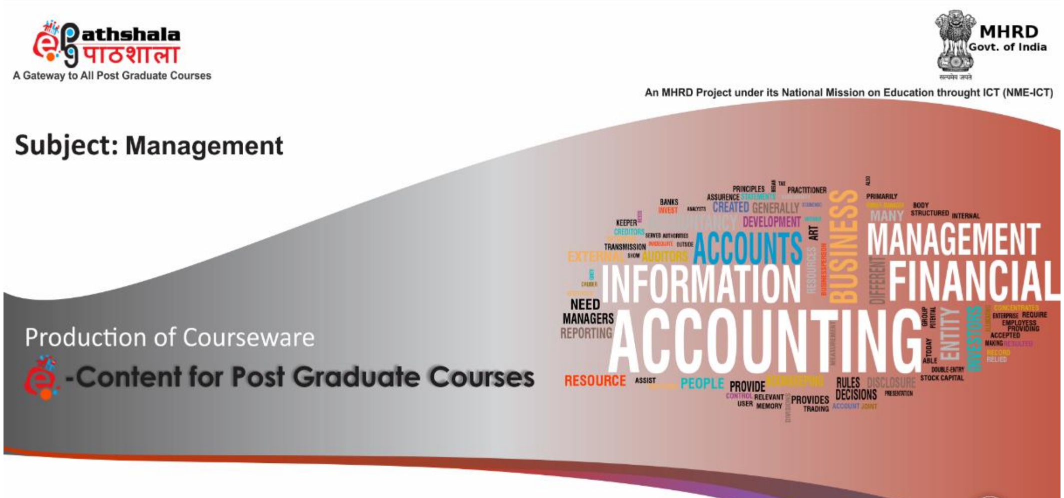

Paper: 12, BUSINESS ENVIRONMENT

Module: 28, Financial Market Environment

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Learning objectives:

- To introduce with types of investors and their investment objectives
- Identify the components of financial market environment
- Describe how the components of financial environment are integrated
- Explain how financial markets environment has become internationalized

[1] Introduction

Financial deals bring two different identities together; wherein one side has party that has shortage of funds and on other side there is a party who has surplus funds. Fund seekers want to get liquid funds and are willing to pay cost for it. Whereas fund investors have wish to channelize their savings in most optimal way so as that they may earn maximum return on it. Financial markets have an important role to play in this financial environment. Financial market introduces borrower and suppliers together so that investment objectives of both can be met.

Financial environment emerges when different individual and institutional investors enter in this market with different investment objectives. Investors are generally categorized in three different types depending on their willingness to assume risk. Aggressive investors are the one who wish to take maximum risk with objective to earn above average return. On the other extreme are conservative investors who wish to take lowest degree of risk and are satisfied with minimum assured return. Within these two extremes lie balanced investors who will prefer to take calculated risk and will like to get return higher than risk free return.

Investors are an important building block of financial environment. However, this is most diversified component as investors plan to invest with different investment objectives. Investment objective of investors may include tax planning, capital appreciation, enhanced liquidity, assured return, long term return etc. These investors prefer to select different financial products (Financial instruments) based on these varied investment objectives. Selection of these financial products is also affected by investors' decision to select a particular combination os assumed risk level and preferred return.

[2] Components of the Financial Environment

The complete system of financial environment comprises of four important components. These include (1) financial managers (2) investors (3) financial markets and 4) Financial instruments. This chapter has provided in depth insight on each of these components in detail and illustrates how they are integrated. The main objective of this chapter is to introduce each component and briefly explain how these components are related. In the forthcoming sections, brief description of these components has been provided.

2.1 Financial Managers

Decision of investing funds lies with financial managers. Financial managers are responsible for taking decision on acquiring the funds for business and appropriately investing those funds. Finance manager is accountable on the issue of how to obtain funds (financing) and where to invest a company's funds to expand its business. The actions taken by financial managers to make financial decisions for their respective firms are referred to as financial management (or managerial finance). Financial managers are expected to make financial decisions in such a way to optimize risk return trade off so as to ensure maximum value of the firm and ultimately maximize the value of the firm's stock price. Hence, the final focus of finance manager is to take financial decisions in a way that may ensure maximum wealth to the shareholders.

2.1.1 Financing Decisions by Financial Managers

One of the important decisions to be taken by finance manager is to arrange required funds for the business needs. However, while procuring these funds for the firm he has option to arrange it through either debt financing or equity financing. In debt financing, borrowed funds are used to finance investments in projects. For example, firms can obtain loans or can issue debt securities, which are certificates representing credit provided to the firm by the security's purchaser. Incase of arranging funds through equity financing, required funds are arranged by offering ownership in the firm to the investors. Further, these funds are used to finance investments in projects. In case of arranging funds through equity financing firms have option to either retain some of their earnings or come up with new issue i.e. issuing equity securities (stocks). These stocks are certificates representing ownership interest in the issuing firm. Selecting and deciding a balance between quantum of debt financing and equity financing is to establish a linkage between short-term and long-term financing. Hence, time factor plays an important role in the decision of firm to design their capital structure. Hence, for a finance manager determining the optimal sources of financing at a given point in time is important issue. Among the decision to balance between debt and equity financing, a finance manager is also required to have in-depth analysis of the financing alternatives, costs associated with procuring those funds and finally, long-run implications of this decision.

2.1.2 Investment Decisions by Financial Managers

Investment decision is among the two important decisions taken by finance managers. Responsibility of financial managers is to identify and assess budding investment opportunities for the business and finally, to determine and decide if they may pursue with those opportunities. The investment decisions of financial managers significantly affect the firm's degree of success, because they determine what types of businesses their respective firms engage in. Investment decisions determine the composition of assets found on the left-hand side of the balance sheet: The financial manager needs to take a balanced decision on investing funds in long term fixed assets and to keep some funds in cash or near money assets to meet working capital requirements of the business. Finance manager attempts to maintain optimal levels of each type of current asset, such as cash and inventory. He is also required to decide which fixed assets (such as buildings or machinery) to invest in and when existing fixed assets need to be purchased, modified, replaced, or dispose off. These decisions are very crucial as they have significant affect the firm's success in achieving its goals.

3. Investors

Investors may be individuals or institutions who have surplus funds and are willing to provide these funds to borrowers such as firms, government agencies, individuals or other institutions. This section provides a brief insight on investors and how do they create provision of funds? Individual investors are generally small investors who commonly provide funds to firms by purchasing their securities (equity shares or debt securities). Second category of investors includes institutional investors. The financial institutions that provide funds are referred to as institutional investors. Some of these institutions focus on providing loans, whereas others commonly purchase securities that are issued by firms.

3.1 Debt Financing Provided by Investors

Debt financing to firms is provided in various forms by individual and institutional investors. Individual investors who wish to take least risk and want to get assured return will prefer to invest their funds in debt securities. However, financial institutions have different constraints to prefer investment in debt securities. One special feature of financial institutions providing debt financing is that they generally invest their funds in bulk so, for this reason they have to maintain a separate loan division who monitor this complete process. For this purpose, financial institutions are required to employ loan officers whose main responsibility is to finalize the credit worthiness of the borrower by evaluating the financial condition of potential borrowers. It is worth mentioning here that main reason for the financial institutions preference to invest in debt securities is to receive compensation as periodic interest payments on the funds offered by them as loans to the borrower. Fixed maturity period is another feature that attracts both individual and institutional investors for debt financing. Hence, debt financing is provided for a specified maturity date at which the amount borrowed has to be paid back. In another form of debt financing, individual investors and financial institutions purchase debt securities that are issued by firms and governments. Sometimes borrowers try to attract investors by offering them dual return as along with fixed interest on principal amount they are offered some discount from its principal value, so that the principal they are repaid at maturity exceeds the amount they paid for the debt security. In addition to this investors may also be lured by the cumulative periodic interest payments on principal amount. Some of the debt securities have this additional feature that to ensure liquidity investors can sell these to other investors before their maturity. As a result this borrowed amount of loan is transferred to the other investors.

3.2 Equity Financing Provided by Investors

Investors who have desire to get high returns than normal risk free return may prefer to invest in equity securities. A firm collects funds through equity financing by selling their shares of stock to investors. These stocks ensure ownership rights to the investors and each investor who purchases stock becomes an owner of the firm. However, one particular feature of these securities is that there is no maturity on equity investment but investors can ensure the liquidity of these securities by selling the stock they own to other investors in secondary market. Investors who invest in firm's equity stock gets return in the form of dividend on the stock. Equity investors also get benefitted by capital appreciation which results from increase in the share prices of the stock.

3.3 Risk Return trade off

Risk and return are the two most crucial parameters that an investor may evaluate at the very first sight to finalize his investment decision. Investors expect to earn a reasonable return on funds provided by them to borrowers as debt or equity financing. Here, return on any investment refers to the actual benefit received by the investor for holding a particular investment for a definite period. However, how much return an investment will earn is highly dependent on decisions of the financial managers, who is responsible for taking investment decision. Hence, if financial managers use their diligent skills to wisely invest funds received from investors in very profitable projects, the firm earns a high return on its investments. As a result even investors who invested in the firm's stock earn a high return on their investment. And vice versa is that negligent decisions by a financial managers will result in poor returns on the firm's investments. Finally, this poor decision will assure lesser returns to the shareholders who invested in the firm's stock.

Almost every kind of investment decisions are exposed to risk because of the presence of the uncertainty in financial market environment. Degree of this risk may vary for different kind of investments. Risk-averse investors always prefer less risk for a given expected return. Even investors decision to invest in debt securities also has some default risk, in terms of assured timely return of borrowed funds. Equity investment carries more risk. When investors select equity securities, they must have idea that there is no fixed guaranteed return on this investment. Return on their investment may be lower or higher than expected. This variation in terms of lower returns may be if the firm performs worse than expected and does not declare expected dividends or it may be if no capital appreciation is earned because stock price does not rise.

4 The Financial Markets

Financial markets represent place/ market that facilitate the flow of funds among investors and borrowers. In financial markets investors and borrowers trade financial securities, commodities and other fungible items at a price determined by demand and supply. Financial markets are

typically defined by having transparent pricing, basic regulations on trading, costs and fees and market forces determining the prices of securities that trade.
Hence, financial markets refer to an organized institutional structure or mechanism for creating and exchanging financial assets. An important component of these financial markets is financial institutions that act as intermediaries. Financial markets can be

a) Capital markets
b) Money market

Capital Markets: This market segment of financial markets facilitates trade of long-term debt and corporate stock. In capital markets securities traded have maturity period of more than one year. Capital market is a market where buyers and sellers engage in trade of financial securities like bonds, stocks, etc. The buying/selling is undertaken by participants such as individuals and institutions. Capital market may be equity market or debt market.

The *equity market* refers to the one where the sale of equity stock takes place by firms to investors. Buyers and sellers of stock get agreed-upon a definite price to buy/sell equity shares. These prices of securities are highly sensitive in equity markets. The *debt markets* enable firms to obtain debt financing from institutional and individual investors or to transfer ownership of debt securities between investors. Financial institution serves as intermediary for trade of bothy equity and debt securities. It is very common for one financial institution to act as the institutional investor while another financial institution serves as the intermediary for execution of a particular trade transaction

Money Markets: These are the markets for debt securities where short term securities are traded. Securities bought and sold in money market have maturities of one year or less. Securities traded in money market are Treasury bills, banker's acceptances, Certificate of deposits, commercial paper etc.

4.1 The Cost of Money

Any investors who sacrifice the use of funds and invest it in financial markets usually expect the borrower to pay a nominal Rate of Interest (k). Hence, the price paid by borrower for borrowing money is cost of money he has arranged. This is usually referred as a percentage rate over a period of time and reflects the rate of exchange of present consumption for future consumption.

Risk-Free Rate (k_{RF}): The rate earned on a riskless investment usually government securities carry risk free rate.

- Inflation Premium: It refers to premium resulting from expected inflation over a period of time.
- Default Risk Premium: Risk associated with default on a loan by the borrower.
- Liquidity Premium: Premium arising due to lack of liquidity.
- Maturity Risk Premium: This risk reflects the degree of interest rate risk because of changes in the interest rate over a period of time.

5 Financial Instruments

Financial instruments refer to tradeable securities of financial markets. These financial instruments may represent cash, ownership interest or contractual right to pay/receive money. Broadly, financial instruments can be of two types:

a) Cash instruments
b) Derivative instruments

Cash instruments are the one whose value is directly determined by the market e.g. deposits and loans. Whereas value of derivative instrument is derived from underlying asset e.g. forward, options, swap etc.

6 Integration of Components in the Financial Environment

Job of a finance manager starts as soon as a firm require funds to meet out their financial obligations. Hence, they start looking for investors who have surplus investible funds. Hence, financial planning on the part of firm's financial managers will try to estimate how much funds the firm needs to invest in its business. At the same time they will try to locate prospective investors from where the firm will obtain funds. Integration of financial markets have benefitted both borrowers and investors by improving their assess from domestic markets to international markets also.

In simple words, through financial markets' integration domestic investors can buy foreign assets and foreign investors can buy domestic assets. Further, integration of financial markets in world wide economy has also stream lined the complete processes of financial trading. As a result financial assets having similar risk command the same expected return regardless of location of origin of the asset. All this has become possible because of uniformity in accounting and financial standards among countries that are fully integrated into world financial markets.

Financial integration is a novel phenomenon through which financial markets of global economies have come close and linked together so that investors may extend their reach to other economies. Improved level of information and communication technology has made it possible by enhancing connectivity of investors and borrowers. Financial markets' integration ensure:

- Sharing of information among financial institutions
- Sharing of best practices among financial institutions
- Sharing of newly introduced technologies among financial institutions
- Assess of borrowers to raise funds directly from the international capital markets;
- Design newly engineered financial products
- Rapid adaption/copycat of newly engineered financial products among financial institutions in different economies
- Cross-border capital flows

However there are few imperfections that may restrict integration of financial markets. Hence, the imperfect financial integration can stem from the inequality of the marginal rate of substitutions of different agents. Further, besides these financial market imperfections there are few legal restrictions that can also hinder financial integration. So in order to achieve financial integration in totality there is a need to remove the restrictions pertaining to cross-border financial operations and to have a common consent on (a) financial institutions to operate freely (b) permit businesses to directly raise funds or borrow and (c) equity and bond investors to invest across the state line with fewer restrictions.

Although legal restrictions need to remove for financial integration of financial markets yet an important point to note here is that legal restrictions are among the best devices to deal with the market imperfections. Hence, complete elimination of the legal restrictions can make the world economy become worse off. For proper financial integration, neighboring, regional and/or global economies can agree upon through a formal international treaty which the governing bodies of these economies agree to cooperate to address regional and/or global financial disturbances through regulatory and policy responses.

During the last two decades, many developing countries have encouraged inflows of capital by withdrawing restrictions, introducing autonomy in domestic financial markets and by initiating market-oriented reforms. India has also shown its strong presence in the financial integration process since 1990. This is quite evident from the structural reform introduced in India to enhance the productivity and efficiency of the economy as a whole so as to make it internationally competitive. Universal banking, deregulation of interest rates, reduction of Cash reserve ratio (CRR) and Statutory reserve ratio (SLR), repeal of FERA Act, aligning call money rates and exchange rates with LIBOR are few actions taken by Indian economy in support of financial integration. Despite the fact that Indian regulatory bodies have taken many actions to support the financial integration yet this ongoing initiative programs needs to be accelerated to further deepen the degree of convergence between the overseas and domestic markets.