TARGET PRELIMS 2024
BOOKLET-53; ECONOMY-13

PRELIMS MASTERS PROGRAM
ECONOMY-19
CAPITAL MARKET

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2. CAPITAL MARKET – FUNDAMENTALS:

- A capital market is the financial market for long term fund. It helps to generate bulk fund for government and industries.

- The most common capital markets are the stock market and the bond market.
    - **The stock market** allows companies to raise capital by selling shares of ownership in the company (**Equity Financing**).
    - **The Bond Market** allows companies and governments to raise capital by selling bonds (**Debt Financing)**.

- **Securities Market** deals with shares (equity shares, preference shares, derivatives) and debt instruments.
    - **In case of Shares** (Equity financing), investors have a share in the capital and profit.
    - In case of **Debt Financing Instruments**, the investors don't have any share in the capital.
        - Companies use Debt Financing instruments (bonds, debentures) to raise funds.
        - It is just lending to the company and the company is liable to pay interest on the capital borrowed through bonds. Regardless of profit and loss the debt instrument holders are entitled to receive income.
        - **Note**: Debentures are a type of bond. Any **unsecured bond without any collateral** is a debenture.
            - All debentures are bonds, but not all bonds are debentures. Whenever a bond is unsecured, it may be referred as debentures.
        - **Note**: Both bonds and debentures may be convertible (meaning that they can be converted into company stocks)

1) KEY DIFFERENCES BETWEEN SHARES, DEBENTURES AND BONDS

Shares	**Debentures**	**Bonds**
Shares are fractions of the company's capital.	Debentures are medium/long term **debt instruments** that a company issues to borrow capital.	Bonds are long term **debt instruments** that companies issue to borrow capital.
Performance of shares is highly dependent on market fluctuation.	Debentures are risky investments as they are usually not backed by collateral. Investor makes investment decision on the basis of credit rating and reputation of the company.	Bonds are safer investment option, as it is backed by collateral.
Shareholders are company owners who own the fraction of company equivalent to fraction of shares held by them.	Debenture holders are lenders to the company.	Bond holders are lenders to the company.

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The company may pay <u>dividend to the shareholders</u> in case the company makes profit.	Debenture holders <u>receive interest payments</u> periodically. It depends on <u>issuing company's performance</u>.	Bond owners receive <u>interest on accrual basis</u>. It doesn't depend on the <u>company's performance</u>.
Shares are **<u>highly liquid</u>** as they can be sold or purchased on stock exchanges.	Debentures has <u>lower liquidity</u> when compared to shares	<u>Bonds</u> have the least liquidity as these are <u>long term debt instruments</u>.
Shares <u>don't have credit rating</u>.	Debentures <u>receive credit rating</u> from CRAs.	Bonds receive credit ratings from CRAs.

2) SHARES (EQUITY, PREFERENCE, DERIVATIVES)

A) EQUITY SHARES

- Equity shares are <u>ordinary stocks issued by a company</u> for the purpose of raising capital to expand their business. The <u>investor gets partial ownership</u> of the company. The number of equities shares an investor buys is their portion of ownership in the company. Equity shares are **<u>non-redeemable</u>**, and therefore act as a <u>long-term source of financing</u> for companies.
- **Benefits**: Capital Appreciation; Dividends.
- However, <u>these benefits are not fixed</u> and are fluctuating.

B) PREFERENCE SHARE

- Preference shares carry <u>preferential rights</u> in terms of <u>dividend payment</u> and <u>repayment of capital</u>.
    - These shares <u>offer shareholders **fixed dividends**</u>.
    - Preferred shareholders are <u>given their dividends before equity shareholders</u> receive theirs.
    - In terms of priority and repayment of capital, <u>preference shares</u> can be <u>ranked between debt and equity</u>.
    - In case of <u>bankruptcy</u>, preferred shareholders get <u>priority over common shareholders</u> and receive the company's assets before them.
    - At any point of time, <u>preference shares can be converted into **equity shares**</u>.
    - Preference shares <u>can be redeemed after a certain period</u> or after the company successfully achieves desired goals.
- **Limitations**: Preference shareholders **<u>don't get right to vote</u>** <u>or participate in decision-making events of the company</u>.

C) DERIVATIVES

- Derivatives are <u>vastly different equity stocks</u>. They are **<u>contracts that derive their value from an underlying asset</u>** – which could be an equity stock, a currency pair or a commodity. This leads to <u>different types of securities</u> like equity derivatives, commodity derivatives, and currency derivatives.

- Derivatives can also be <u>classified as **futures and options**</u> based on the <u>terms of contract</u>.
    - **Futures**: In a future contract, two parties decide to <u>purchase and sell the underlying asset</u> at a specific price on a specific date in the future. This contract <u>must be executed by both parties</u>, and neither party has the right to let the contract expire.

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- **Options**: Options contract also <u>derives its value from an underlying asset</u>. It gives the holder (or the buyer) of the <u>options contract</u> the <u>right to purchase or sell the underlying asset</u> at a fixed price on or before a specific date. The options <u>buyer is not obligated to carry out the terms</u>. Options contracts can be <u>any one of two types</u> – namely, <u>**call options**</u> that offer the right to <u>buy the asset</u> and <u>**put options**</u> that offer the right to sell the asset.

3) GOVERNMENT AND INDUSTRIAL SECURITIES

- <u>**Based on the fund raiser**</u>, the securities market can be classified into two types: 1) **Government Securities Market** 2) **Industrial Securities Market**

A) GOVERNMENT SECURITIES MARKET

- It is a market of government and semi-government securities backed by RBI. It is also known as <u>**Gilt Edged Market**</u>. Gild edged means "**of the best quality**". The government securities are <u>more reliable</u> and therefore they are called <u>Gild Edged Securities</u>.

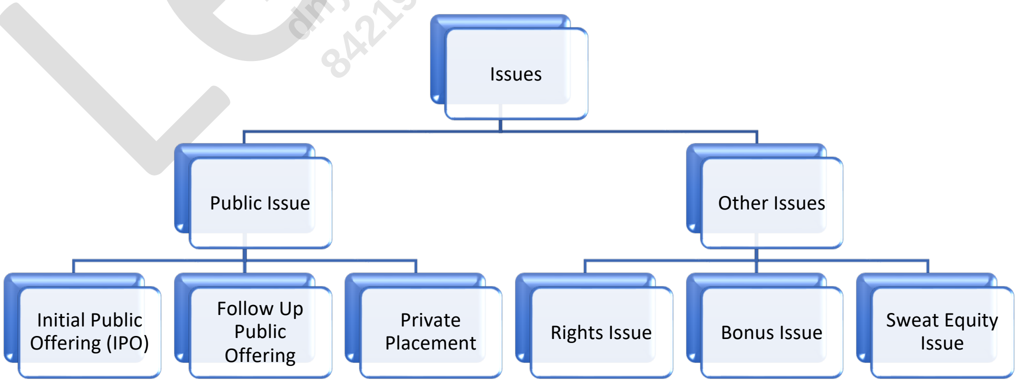
B) INDUTRIAL SECURITIES MARKET

- It is a market for securities of <u>industrial and commercial organizations</u>.

4) NEW (PRIMARY) AND OLD ISSUE (SECONDARY) MARKET

- Based on the nature of issue, the <u>securities market can be classified as **New Issue Market (Primary Market)**</u> and <u>**Old Issue Market (Secondary Market)**</u>.

- **Primary Market**: Here, <u>new securities are issued</u> for the first time. <u>**Companies/governments raise capital** by selling stocks, bonds, or other financial instruments to investors</u>.
  - <u>**E.g.:**</u> Initial Public Offerings (IPOs) for stocks and issuance of government bonds.
  - The issue of securities in Primary Market can be classified as: **1) Public Issue 2) Other Issues**



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- **Public Issue** means issue of securities to public i.e. to all people, whoever wants to invest.
    - **IPO:** If a company or financial corporation (issuer) issues shares for the first time.
    - **FPO**: If any company or corporation has already issued shares, issues shares again, to raise additional funds it is called Follow on Public Offering.
    - In both IPO and FPO, the issuer usually doesn't issue the security, the issuer appoints a merchant banker on behalf of it to carry out the fund raising activities.
    - **Authorized Capital, Issued Capital, Subscribed Capital**:
        - The issuer can issue to the extent of Authorized capital. Authorized capital means the maximum amount authorized by the Memorandum of Association (MoA) of a company that can be raised by the company. A company need not issue the shares to the extent of authorized capital. It can issue less than the authorized capital. The actual amount issued by the issuer is called **Issue Capital**.
        - **The Subscription** may be sometimes less than the issue capital. It it is so, then it means it is unsubscribed. The actual amount of subscribed is called **subscribed capital**.
    - **Private Placement** includes offering shares directly to financial institutions, mutual funds, and high worth investors.

- **Other Issues**:
    - **Right Issue**: Offer of security to existing shareholders in the FPO. It flows to the existing shareholders as a matter of legal rights. So, it is called the Rights issue.
    - **Bonus Issue**: It refers to the offer of shares against distributable profit to the existing shareholders. It is also known as the scrip issue or the capitalization issue.
    - **Sweat Equity Issue**: It denotes offer of shares to employees or Directors o the company which issues shares as recognition of their hard labour (sweat), which results in contribution to the company in the form of intellectual property rights, technical know-how etc.

- **Secondary Market** (Old Issue Market): Here, previously issued securities are **traded among investors**.
    - E.g. Stock market where investors buy and sell shares, Bond trading platforms.
    - **Stock Exchange**: It is an institution for orderly buying and selling of listed securities.
    - **Over the counter exchange**: Platform for trading in securities that are 'not listed' on a recognized stock exchange.

- **Regulation**: In India, both New Issue and Old Issue markets are regulated by the Securities and Exchange Board of India (SEBI).

5) STOCK EXCHANGES

- In India, there are several small and big stock exchanges. The most prominent are National Stock Exchange (NSE) and Bombay Stock Exchange (BSE).
- **National Stock Exchange (NSE)** was incorporated in 1992 on the recommendation of Pherwani Committee. **IDBI** is the main promoter of the exchange. Some other leading financial institutions (SBI, LIC etc) are also promoters of its along with IDBI.

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- **Bombay Stock Exchange** (BSE): Established in 1887. It is Asia's oldest Stock exchange and was initially known as 'The Native Share and Stockbrokers Association'. It was owned by stock brokers. Now it is demutualized (i.e. made a public owned organization).

A) INDEX

- Like CPI and WPI which measure the rise/fall in the price of commodities, there are share price indices which measure the rise and fall of a bucket of shares. The most prominent indices in India are **Sensex**, **Nifty**, **and Nifty Junior**.
- **Sensex** stands for **Sen**sitive Ind**ex**. This is the index of the BSE and measures the price movement of top 30 company shares. The top 30 companies are called Blue Chip Companies.
- **NIFTY** stands for **N**ational **I**ndex for fi**fty**. This and Nifty junior are the indices of National Stock Exchange. NIFTY measures the price movement of **top 50 companies**. Nifty junior is an index of **next 50 top companies**.
- **How are top companies selected:** On the basis of total value of shares that are traded in the stock exchange.
    - **Value of traded shares** = Price of one share x Number of shares traded
    - This value is called **free float market capitalization**. The value of all (both traded and non-traded (the shares that are kept for a long time)) shares is called **market capitalization**.
    - **Market Capitalization** is the value of shares that were sold to public which are called outstanding shares. Market Capitalization = Price X Total outstanding shares.

6) INDEX PROVIDERS

- **Index Providers** are companies that design, create, calculate and manage indexes. They have the responsibility to set the rules that decide what securities to include in each index, how the index will be managed, and how securities will be added or removed from that index over time.
    - **Examples of Index Providers**: MSCI, Standard & Poors (S&P), Dow Jones, Nasdaq, FTSE Russell, Solactive, Morningstar
    - **Note**: The first index - Dow Jones Transportation Average - was created in 1884 to measure average performance of railroad stocks in the US.

- **In India**, Index providers are subsidiaries of stock exchanges.
    - For e.g.
        - **NSE Indices Ltd:** It is the largest index provider in India. It manages the popular Nifty indices, including the benchmark Nifty 50 Index, Nifty Bank Index etc.
        - **Asia Index Pvt Ltd** (APIL): It is a 50-50 partnership between S&P Dow Jones Indices LLC, the world's largest provider of financial market indices and BSE Ltd, Asia's oldest stock exchange and home to iconic SENSEX Index.

- **Regulation of Index Providers**:

A) SEBI NOTIFIED THE 'SEBI INDEX PROVIDER REGULATIONS' (MARCH 2024)

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- SEBI has **mandated registration of index providers** managing "significant indices" based on securities listed in India.
  - » **The global index providers**, however, may not have to register under the SEBI unless indices are used as benchmarks by domestic asset managers with large corpus.
  - » SEBI has excluded indices that are exclusively used in a foreign jurisdiction.
  - » Benchmarks regulated by RBI are also excluded from these regulations.
  - » Industry players like NSE limited, APIL etc. will have to register with SEBI
- Other than registration, the index providers covered under the regulation will also have to make the methodology documents public, follow a code of conduct, and bring more transparency on inclusion and exclusion.
- **Significance:**
  - » It is aimed at fostering transparency and accountability in governance and administration of financial benchmarks in the market.

7) DEPOSITORIES

- **Basics**
  - » Depositories are institutions that keep securities of investors in **electronic format** (demat format).
    - The change in ownership of shares is done electronically.
  - » Depository is an institution or a kind of organization **which holds securities with it**, in which trading is done among shares, debentures, mutual funds, derivatives, F&O and commodities.
  - » **Intermediaries** perform their actions in variety of securities at Depositary on behalf of their clients. These intermediaries are known as **Depositary Participants(DPs)**. Depository interacts with its client / investors through its agents, called DPs. For any investor/client, to avail services provided by the Depository, has to open a depository account known an **Demat A/c**, with any of the DPs.
    - ▪ The relationship between the DPs and the depository is governed by an agreement made between the two under the Depositories Act.
    - ▪ In a strictly legal sense, a DP is an entity who is registered as such with SEBI under the subsection 1A of Section 12 of SEBI act. As per the provisions of this act a DP can offer depository related services only after obtaining a certificate of registration from SEBI.
- **In India**, there are two depositories **NSDL, Mumbai** and CDSL, Mumbai
  - » National Security Depositary Limited(NSDL): It is the first depository in the country. It was established by UTI, NSE and IDBI.
  - » Central Depositary Service (India) Ltd (CDSL).
    - It was established by BSE, Bank of India, Bank of Baroda, SBI and HDFC Bank.

8) SEBI (SECURITIES AND EXCHANGE BOARD OF INDIA)

- SEBI is the regulator for the securities market in India. It was established in the year 1988 and given statutory powers on 12th April 1992 through the SEBI act, 1992.
- **Functions and Responsibilities**
  - ▫ **Basic Function:** The Preamble of the Securities and Exchange Board of India describes the basic functions of the SEBI as "to protect the interests of investors in securities and to promote the

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development of, and to regulate the securities market and for matters connected therewith or incidental thereto.

- SEBI has to be responsive to the **needs of three groups**, which constitute the market:
  - » The issuer of security
  - » The investors
  - » The market intermediaries

- SEBI has three functions rolled out into one body: **quasi-legislative, quasi-executive and quasi-judicial**.
  - » It drafts regulation in its legislative capacity.
  - » It conducts investigation and enforcement action in its executive function.
  - » It passes rulings and orders in its judicial capacity.

- Though, this makes it very powerful, there is an appeal process to create accountability. There is a **Securities Appellate Tribunal** which is a three-member tribunal. A second appeal lies directly to Supreme Court.
- SEBI has taken a very proactive role in streamlining disclosure requirements to international standards.

- **Composition:** The SEBI is managed by its members, which consist of **Chairman and 8 other members**.
  - The **chairman** is nominated by the Union Government of India
  - **Two members** i.e., officers from Union Finance Ministry
  - **One member** of reserve bank of India
  - The **remaining five members** are nominated by Union government of India, out of them **at least three shall be whole-time members**.

9) RELATED TERMS

1. **P/E Ratio**: Price to Earning Ratio, is a metric used to assess a company's stock valuation. It essentially compares a company's share price to its earning.
2. **Face Value and Issue Price**:
   - Face value is the actual value of shares. It is a fixed nominal value assigned to a share by the company during its incorporation.
   - **Issue Price** is the price at which company shares are sold to the public for the first time during an IPO.
     - Premium is the extra price a share claims in the market due to high demand for it.
3. **Short Selling**: Sellers sells the securities without owning the securities. He borrows the securities and sells it.
4. **Beta:** It is a measure of stock's volatility in relation to the overall market.
   - By definition, the market has a beta of 1.0 and individual stocks are ranked according to how much they deviate from the market.
5. **Bull and Bear Trading**:
   - In bull trading, buyer buys more shares in expectation of price increase in future.
   - In Bear trading, the sellers sell the securities, with the intention to avoid loss, in the expectation that the security prices will fall.

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6. **Buy Back**: Issuer buying the securities again to accumulate shares in his hands.

10) PARTICIPATORY NOTES (P-NOTES)

- **Introduction**
  - PNs (ODIs) are instruments issued by the registered foreign institutional investors (FIIs) to overseas investors, who wish to invest in the Indian stock markets without registering themselves with the market regulator, the SEBI.
    - FIIs use these instruments for facilitating the participation of their overseas clients, who are not interested in participating directly in the Indian stock market.
- **Advantages for investor**
  - **Anonymity:** PNs allows large hedge funds to carry out their operations without disclosing their identity
  - **Ease of trading** as participatory notes are like contract notes transferable by endorsements and delivery.
  - **Tax Saving** as the investor can invest through tax haven countries.
- **Advantages for India**
  - **More** Investment in the country
- **Key Controversy**
  - **Hides the identity of the investor**
    - **According to a white paper on black money by government, a considerable portion of PNs are used by wealthy individuals as a mechanism to channelize black money kept in foreign countries to India.**
    - **SIT on black money has also called for phasing out of the participatory notes.**
  - **Money Laundering**
    - P-notes has become one of the key money laundering mechanism in the country.
- **SEBI has not banned P-Notes** because:
  - Used globally in many markets
  - SEBI believes that P-notes are legitimate instruments required for normal financial transactions and are prevalent in all the larger markets.
  - Then there are business reasons to permit these transactions through P-notes.
- **SEBI has taken a number of steps to tighten the norms**

11) GLOBAL DEPOSITORY RECEIPTS

- A GDR, also known as International Depository Receipt (IDR), is a certificate issued by a depository bank, which purchases shares of foreign companies and deposits it on the account. They are the global equivalent of the Original American Depository receipt (ADR) on which they are based.
- GDRs represent ownership of an underlying number of shares of a foreign company and are commonly used to invest in companies from developing or emerging markets by investors in developed markets. GDRs enable a company, the issuer, to access investors in capital markets outside of its home country.

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3. DEBT SECURITIES

1) WHAT IS A DEBT MARKET?

- The debt market is the market where fixed income securities of various types and features are issued and traded. This includes fixed income securities from governments, municipal corporations, government bodies, and commercial entities including Financial Institutions, Banks, PSUs, Public Ltd companies etc.

What are the different types of instruments which are traded in debt market?

Market Segment	Issuer	Instruments
Government Securities	Central Government	Zero Coupon Bonds, Coupon Bearing Bonds, Treasury Bills, STRIPS
	State Governments	Coupon Bearing Bonds
Public Sector Bonds	Government Agencies / Statutory Bodies	Govt. Guaranteed Bonds, Debentures
	Public Sector Units	PSU Bonds, Debentures, Commercial Paper
Private Sector Bonds	Corporates	Debentures, Bonds, Commercial Paper, Floating Rate Bonds, Zero Coupon Bonds, Inter-Corporate Deposits
	Banks	Certificates of Deposits, Debentures, Bonds
	Financial Institutions	Certificates of Deposits, Bonds

Note-1: **STRIPS – Separate Trading of Registered Interest and Principal of Securities:** STRIPS are the securities created by way of separating the cash flows associated with regular G-Sec i.e. each semi-annual coupon payment and final principal payment to be received from the issuer, into separate securities. They are essentially **Zero coupon bonds**. However, they are created out of existing securities only and unlike other securities, are not issued through auction. Being G-Sec, STRIPS are eligible for SLR.

Note-2: The G-Secs are known as **SLR securities** in the Indian markets as they are eligible securities for the maintenance of SLR ratio by the banks.

2) WHAT IS MONEY MARKET?

- The money market is basically concerned with the **issue and trading of securities with short term maturities and quasi-money instruments**.

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- Instruments traded in money market are: Treasury Bills, Certificate of Deposits (CDs), Commercial Papers, Bills of Exchange and other instruments of short term maturities (i.e. not those exceeding 1 year with regard to the original maturity).

- **Treasury Bills** (already studied with fiscal policy chapter)

- **Certificate of Deposits** (CoD): A CoD is a saving product that earn interest on a lump sum for a fixed period of time. CD differs from saving account as the money has to remain **untouched for the entire period** or risk penalty fee or lost interest. It has higher interest rates than saving accounts as an incentive for lost liquidity. They are safer and more conservative investment than stocks and bonds, offering lower opportunity for growth, but with a non-volatile, guaranteed rate of return. Virtually every bank, credit union, and brokerage firm offers a menu of CD options. Although you lock into a term of duration when you open a CD, there are options for exiting early should you encounter an emergency or change of plans.

- **Commercial Papers:** Commercial Paper is an **unsecured, short-term debt instrument** issued by corporations. It's typically used to finance short term liabilities such as payroll, accounts payable, and inventories. It is usually issued at a discount from face value i.e. the commercial paper is issued at a discount and matures at its face value. It reflects prevailing market interest rates.

- **Bill of Exchange**: A bill of exchange is a written document used primarily in international trade. It's essentially an instruction from one party (the drawer) to another party (the drawee) to pay a fixed amount of money to a **third party** (the payee) at a specific date in the future, or on demand.
  - **Drawer**: The person or entity who creates the bill and instructs the payment.
  - **Drawee**: The person or entity who is instructed to make the payment (often the buyer in a trade transaction)
  - **Payee**: The person or entity who is supposed to receive payment.

3) ADVANTAGE OF DEBT SECURITY FOR INVESTORS

- Predictable stream of payments.
- Debt securities like government bonds are also highly secure and very less volatile.
  - **Note**: The return earned on the government securities are normally taken as the **benchmark rates of returns** and are referred to as the risk free return in financial theory. The Risk-free rate obtained by G-Sec rates is often used to price the other non-government securities in financial market.
- It indicates wide-based efficient portfolio diversification.

4) IMPORTANCE OF DEBT MARKET TO THE ECONOMY:

- Efficient mobilization and allocation of resources
- Financing the development activities of government
- Transmitting signals to monetary policy.
- Development of heterogeneity among market participants

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5) DIFFERENT TYPES OF RISKS ASSOCIATED WITH DEBT SECURITIES

i) **Default Risk** (Credit Risk): When issuer of a bond is unable to make timely payment of interest or principal on a debt security.

ii) **Interest Rate Risk**: This can be defined as the risk emerging from an adverse change in the interest rate prevalent in the market.
   - **E**.g. Upswing in the prevailing interest rate scenario leading to a situation where the investors' money is locked at lower rates.

iii) **Reinvestment Rate Risk**: Probability of a fall in the interest rate resulting in a lack of options to invest the interest received at regular intervals at higher rates than the comparable rates in the market.

6) DEBT SECURITY MARKET STRUCTURE

- The debt markets in India and all around the world are dominated by Government securities which account for 50-75% of the trading volumes and the market capitalization in all markets.
- **In India**, Government Securities (G-Sec) account for 70-75% of the outstanding value of issued securities and 90-95% of the trading volumes in the Indian debt markets.
- **State Government securities & Treasury Bills** account for around 3-4% of thre daily trading volumes.

7) WHO REGULATES FIXED INCOME MARKET (DEBT SECURITY MARKET)?

Government securities and issues by Banks and Institutions are regulated by RBI.
Non-Government securities comprising basically of Corporate Debt issues is regulated by SEBI.

8) BOND ANALYTICS

- **Bond Basics**: When a bond is issued, the issuing entity determines its duration, face value (also called its par value), and the rate of interest that it pays (coupon rate). These characterisitics are fixed, remaining unaffected by changes in the bond's market.
  - **E**.g.: A Government bond with Rs 1 crore face value and a 7% coupon rate pays 7 lakhs in interest annually.

- **What is yield?**
  - Yield refers to the percentage rate of return paid on a stock in the form of dividend, or the effective rate of interest paid on a bond or note.
  - There are **many different kinds of yields** depending on the investment scenario and the characteristics of the investment.
    1. **Current Yield** of Bonds: Current yield of bond is calculated by dividing the annual coupon payment by bond's current market value.
       » **E.g.**
         i. Let's say Bond's face value is Rs 1 crore.
         ii. Coupon is 10%.
         iii. Bond's market value is Rs 1.1 crore.
       » **Current yield in percentage = Annual Coupon Payment/ Bond Price**

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= (10 lakh/ 1.1 crores) = 0.0909 = 9.09%

» **Significance**: The current yield calculation helps investors drill down on bonds that generate the greatest returns on investment each year.

2. **Yield to Maturity**: It is the % rate of return paid on a bond, note, or other fixed income security, if you buy and hold the security till its maturity. It's a more complicated calculation and not relevant for our preparation.

- **How is the Price determined in the Debt Market?**
  - The price of bond in the debt market is determined by the forces of **demand and supply**.
  - The price fluctuates according to change in:
    1. Economic Condition
    2. General Money market condition including the state of money supply.
    3. Interest rate prevalent in the market
    4. Future interest rate expectations
    5. Credit quality of the issuer
  - **There** is, however, a theoretical underpinning to the determination of the price of the bond in the market based on the measure of the yield of the security.

- **Bond Yield as a function of Price**:
  - **Yield and Bond Prices** are inversely related. So, a rise in price will decrease the yield and a fall in the bond price will increase the yield.
  - **When the prevailing interest rate in market rise**, the prices of outstanding bonds will fall to equate the yield of older bonds with higher-interest rates of new issues. This will happen as there will be very few takers for the lower coupon bonds resulting in a fall in their prices.
  - **When the prevailing interest rate in market falls**, the price of outstanding bonds will rise, until the yield of older bonds is low enough to match the lower interest rate on the new bond issue.

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