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Chapter-8 Financial Markets and Government Securities

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Chapter – 8 Financial Markets and Government Securities

Introduction

This session will present the overview of the financial markets as well as the various government securities and instruments, which are traded in the markets. With the learning from this session the basic understanding of the functioning of various markets will take place.

Learning Objective

After reading this chapter you will:

- Understand the various types of markets and their functioning.
- Understand the financial instruments traded in each market.
- Explain the various government securities traded in the markets.

8.1 Financial Markets

Financial Market is a broad term used for the place where a large number of buyers and sellers exchange various types of financial securities (such as stocks and bonds), commodities (such as metals, sugar, and other agricultural products) with each other at low transaction costs. Depending upon the needs and expectations of various individuals and businesses Financial Markets serve various purposes. Financial markets enable the investor to: raise capital, transfer risk and undertake international trade. The financial market can be divided into different subtypes:

The financial markets have two major components:

- Money market
- Capital market.

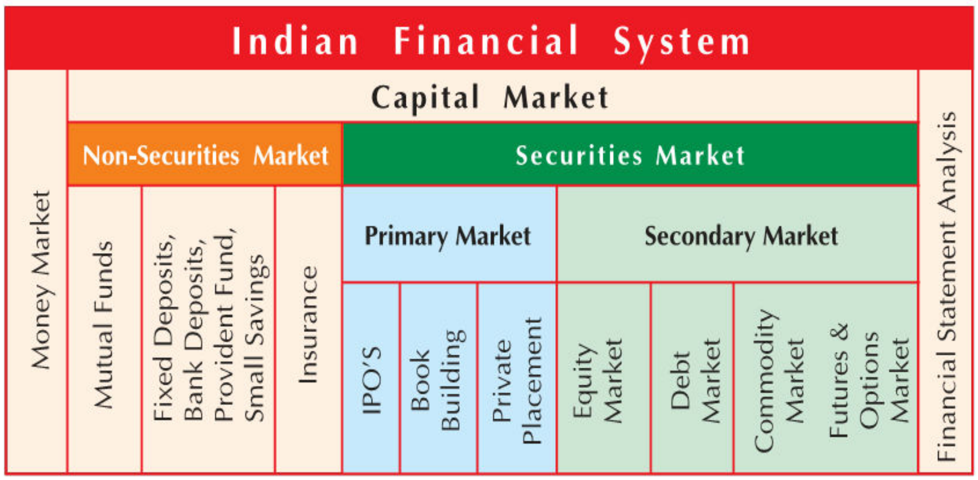
The Money market refers to the market where borrowers and lenders exchange short term funds to solve their liquidity needs. Money market instruments are generally financial claims that have low default risk, maturities under one year and high marketability.

The Capital market is a market for financial investments that are direct or indirect claims to capital. It is wider than the Securities Market and embraces all forms of lending and borrowing, whether or not evidenced by the creation of a negotiable financial instrument. The Capital Market comprises the complex of institutions and mechanisms through which intermediate term funds and long-term funds are pooled and made available to business, government and individuals. The Capital Market also encompasses the process by which securities already outstanding are transferred

- Capital markets:
  - Primary markets
  - Secondary markets
  - Stock Market
  - Debt Market
  - Commodity Market
  - Derivative Market

- Money markets
- Insurance markets
- Foreign exchange markets

Financial market data provides information about the financial market statistics.



(Source: www.cbse.nic.in)

8.2 Capital Market

This market is used by companies and government for raising long-term debt and equity capital. The capital market consists of the primary market, where securities which are newly formed are traded for the first time, and the secondary market, which allows for the sale and purchase of the security or the product of securities.

The capital market includes the stock market and the bond market. The stock market can be defined as a system that enables the trading of company stocks, its derivatives and other securities at agreed upon prices. The bond market is a market where the participants (institutional investors, governments, traders and individuals) buy or sell debt securities in the form of bonds.

i. Primary Market

Primary market is the place where bonds or equities are issued by the companies to raise the capital for the first time. It is also known as the "New Issue Market" (NIM). The capital is raised either using an Initial Public offer (IPO) or a rights issue. The IPO is a first time offering while the rights issue is second time offering to the existing share holders. Any company coming out with a fresh issue operates in the primary market. The issuing company or group receives a cash payment which is then used for the operational activities or for the expansion of the business.

Companies raise funds to finance their projects through various methods. The promoters can bring their own money of borrow from the financial institutions or mobilize capital by issuing securities. The funds may be raised through issue of fresh shares at par or premium, preferences shares, debentures or global depository receipts. The main objectives of a capital issue are given below:

- To promote a new company
- To expand an existing company
- To diversify the production
- To meet the regular working capital requirements
- To capitalize the reserves

In the primary market, securities are priced on an auction basis. Bids are made to buy the bonds. After checking all the bids received at various yield rates, a certain rate is decided as the coupon rate for the security. Allotment of the bid is done to the bidders who bid at the selected yield rate or lower than that. This process of selling the new stock issues by companies to prospective investors in the primary market is called underwriting.

ii. Secondary Market

Secondary market is the financial market for trading of the securities which have already been issued. Secondary market is the place where trade of bonds (or equities) happens between bondholders (or shareholders). Company is not directly connected to secondary market though company's performance affects the bond prices. The secondary markets are highly liquid and transparent. There are financial supervisory authorities to regulate the eligibility of stocks and bonds for trading in the secondary market. Mostly the brokers do the trading on behalf of their clients who own the bonds. In Secondary markets, the bond trading is done at the prevailing market rates. The most traded bonds are called the most liquid bonds. In contrast to the primary market in initial public offerings, which can be seen as the wholesale side of their business stockbrokers use the secondary market as the retail part of their business.

The monitoring of the organized capital market is done by the government; after approval of the new issues by authorities of financial supervision the monitoring is done by participating banks. A good example of secondary market is the New York Stock Exchange. Here all the stock markets are part of the secondary market, as the investors buy securities from other investors rather than from the issuing company or group.

Relationship between the Primary and Secondary Markets

- The new issue market cannot function without the secondary market. The secondary market or the stock market provides liquidity for the issued securities the issued securities are traded in the secondary market offering liquidity to the stocks at a fair price.
- The stock exchanges through their listing requirements, exercise control over the primary market. The company seeking for listing on the respective stock exchange has to comply with all the rules and regulations given by the stock exchange.
- The primary market provides a direct link between the prospective investors and the company. By providing liquidity and safety, the stock markets encourage the public to subscribe to the new issues. The market ability and the capital appreciation provided in the stock market are the major factors that attract the investing public towards the stock market. Thus, it provides an indirect link between the savers and the company.
- Even though they are complementary to each other, their functions and the organizational set up are different from each other. The health of the primary market depends on the secondary market and vice-versa.

iii. Stock Market

Stock Market is a market for the trading of publicly held company stock and their associated financial instruments (including stock options, convertibles and stock index futures). Earlier these markets were open-outcry where trading used to occur on the floor of an exchange. Presently these markets have become cyber-markets with buying and selling occurring using online systems using real-time matching of orders placed by buyers and sellers.

iv. Equity Market

Equity most commonly refers to the stock of a publicly traded company. A firm issues its equity shares at a certain cost to the investors. These shares represent a part of the firm that is now owned by the shareholder.

The equity market is one of the strongest indicators of the macro perspective of an economy. For an investor to decide on whether an investment is worth or not, certain indicators are present in the equity market which help him take the decision.

Various kinds of equity

Equity, also called Stock is broadly divided into two types- Common Stock and preference stock.

Common stock is the most common kind of issue made in the equity market. A firm releases its shares in the stock market (called the primary market if the company is issuing for the first time, secondary market if the shares are traded between the traders), the value of the share is called the 'face value' or the 'par value' of the share. However, the shares may be sold at a premium or discount to the par value, depending on the demand for the share (For example, the Reliance Petro shares were sold at a premium of over 90% on its face value of Rs.60).

Common shareholders own that share of the company (proportional to the amount of the shares they hold) and they have voting rights in the company and a firm that issues equity has to comply with certain norms like having a annual general meeting where it meets the concerns of the equity shareholders at least once a year. The company sometimes issues dividends, which is a percentage of its profits spread over to all the shareholders. However the firm is not obliged to release dividends every year.

A preferred stock holder is assured of annual dividends, whether or not the firm makes profits. The amount of dividend is pre-decided during the time of the issue itself. The voting rights of the preferred stockholders also differ from the equity shareholders. Preferred stock gives lesser rights to the shareholders. If the company goes bankrupt, it is the preferred stockholders who are first redressed, though they come after debt holders (i.e. the firm's debts are first paid off, then preference shareholders are paid off, then the equity shareholders, if anything of the company's assets are left by then).

Firms sometimes issue convertible preferred stock; a certain number of shares can be converted to equity stock at a price after a certain point in time. The conversion ratio denotes the number of common shares an investor might receive for one preferred share of that firm.

v. Debt Market

The markets in which bond are traded before their maturity. It is a place where participants buy and sell securities in the form of bonds. This segment provides a trading platform for a wide range of fixed income securities that includes central government securities, treasury bills (T-bills), state development loans (SDLs), bonds issued by public sector undertakings (PSUs), floating rate bonds (FRBs), zero coupon bonds (ZCBs), index bonds, commercial papers (CPs), certificates of deposit (CDs), corporate debentures, SLR and non-SLR bonds issued by financial institutions (FIs), bonds issued by foreign institutions and units of mutual funds (MFs).

To further encourage wider participation of all classes of investors, including the retail investors, the Retail Debt Market segment (RDM) was launched on January 16, 2003. This segment provides for a nationwide, anonymous, order driven, screen based trading system in government securities. In the first phase, all outstanding and newly issued central government securities were traded in the retail debt market segment. Other securities like state government securities, T-bills etc. will be added in subsequent phases.

vi. Commodity Market

Commodity market is a vital component of the financial market of any country. It is the market where a wide range of products like crude oil, metals, energy and commodities like oil, coffee etc. are traded. It is important for an economy to have a vibrant, active and liquid commodity market. This would not only help the investors to hedge their commodity risk but also to take speculative positions in commodities as well as to avail the arbitrage opportunities in the market. Some of the leading commodity exchanges are New York Board of Trade, National Food Exchange, E.G London Metal Exchange (LME), Multi-commodity exchange India (MCX).

vii. Derivatives Market

Derivatives are financial products whose value is derived from the price of some underlying asset like securities, commodities, bullion, currency, stock market index, interest level or anything else. Derivatives provide a risk hedging mechanism to investors. A derivative is a contract which specifies the right or obligation to receive or deliver future cash flows based on some agreed upon future event. Derivatives markets can be standardized or non-standardized. One such derivatives market is for standardized stock options where the parties can buy or sell the call or put options. Non-standardized derivatives instruments like warrants issued directly by financial institutions to a secondary market, also exist.

In the Indian context the Securities Contracts (Regulation) Act, 1956 (SC(R) A) defines "Derivative" to include –

- A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.
- A contract, which derives its value from the prices, or index of prices, of underlying securities.

The various participants of the derivative market are:

I. **Hedgers** use futures or options markets to reduce or eliminate the risk associated with the price of an asset;

II. **Speculators** use futures or options contract to get extra leverage in betting on future movements in the price of an asset. They can increase both the potential gains and

III. **Arbitrageurs** are in business to take advantage of a discrepancy between the prices in two different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

Types of Financial derivatives - Futures; Forwards; Options; and Swaps. Some other derivatives are Leaps (Long-Term Equity Anticipation Securities, Warrants, Baskets and Swaptios.

8.3 Money Market

Money market means market where money or its equivalent can be traded. Money is synonym of liquidity. Money market consists of financial institutions and dealers in money or credit who wish to generate liquidity. It is better known as a place where large institutions and government manage their short term cash needs. For generation of liquidity, short term borrowing and lending is done by these financial institutions and dealers. Money Market is part of financial market where instruments with high liquidity and very short term maturities are traded. Due to highly liquid nature of securities and their short term maturities, money market is treated as a safe place. Hence, money market is a market where short term obligations such as treasury bills, commercial papers and banker's acceptances are bought and sold.

In the money markets, banks lend to and borrow, short-term financial instruments such as certificates of deposits (CDs) to each other, or enter into agreements such as repurchase agreements (repos). It provides short to medium term liquidity in the global financial system. Money market derivatives include forward rate agreements (FRAs) and short-term interest rate futures.

The markets in which banks lend and borrow from each other using instruments such as Certificates of Deposit (CDs) or enter agreements such as **Repos and Reverse repo**. This market generally trades in maturities of up to one year. Money markets help institutions and government to fulfill their short-term cash needs. Money markets are best known as places where short-term funds are lent and borrowed. In other words money markets are markets for short-term financial assets, which are near substitutes for money.

Some definitions of money markets

- According to the *McGraw Hill Dictionary of Modern Economics*, "Money market is the term designed to include the financial institutions which handle the purchase, sale, and transfers of the short term credit instruments. The money market includes the entire machinery for the channeling of short-term funds. Concerned primarily with small business needs for working capital, individual's borrowing and government short term obligations, it differs from the long-term or capital market which devotes its attention to dealings in bonds, corporate stocks and mortgage credit".

- The *Reserve Bank of India* defines it as, "the centre for dealings, mainly of short term character, in money assets; it meets the short term requirements of borrowers and provides liquidity or cash to the lenders. It is the place where short term surplus funds at the disposal of financial and other institutions and individuals are bid by borrowers' agents comprising institutions and individuals and also the government itself".

The primary goal of this market is to provide short term liquidity in the market. The securities in the money market are highly safe and they offer lower returns than most other securities.

Objectives of Money Market

Well-developed money markets serve the following objective:

- **Equilibrium Mechanism**

  Money markets provide an equilibrium mechanism for ironing out short-term surplus and deficits.

- **Focal Point -** It acts as a focal point for central bank intervention for influencing liquidity in the economy.

The Repurchase Agreement (Repos)

A **repurchase agreement** (or **repo**) is an agreement between two parties whereby one party sells the other a security at a specified price with a commitment to buy the security back at a later date for another specified price. Most repos are overnight transactions, with the sale taking place one day and being reversed the next day. Long-term repos—called **term repos**—can extend for a month or more. Usually, repos are for a fixed period of time, but open-ended deals are also possible. **Reverse repo** is a term used to describe the opposite side of a repo transaction. The party who sells and later repurchases a security is said to perform a repo. The other party—who purchases and later resells the security—is said to perform a reverse repo. Repos are classified as a money-market instrument. They are usually used to raise short-term capital.

Economically, a Repo can be seen as a bank loan, the initiator of the repo takes funds from the other party by giving his securities as collateral. After a certain period, he pays back the funds and redeems his collateral. The difference in the funds paid and received is the interest. Repo is often quoted as an interest rate A Repo for over a day is called a 'term repo'. A repo market is a place where repo transactions take place.

Uses of Repo

Repo is just like a secured loan. A repo is the abbreviation for the repurchase agreement; it represents the legal contract for the sale and subsequent repurchase of a security. The party purchasing the security makes funds available to the repo seller who keeps the government securities with the lender in return and the lender holds the security as collateral. The title of the security passes to the lender or the repo buyer. If the repoed security pays any income during the repo, this is returned to the original owner. The rate at which the lender lends the money to the seller is called repo rate. And is usually the difference between the sales and repurchase prices paid for the security.

Repo is used as the means to maintain the liquidity in the system and also to fulfill the short term needs of the borrowers. E.g. securities dealers use repos to finance their inventories. They repo their inventories, by using roll-over repos (i.e. rolling the repos from one day to the next). Lending party may be institutions, who have short-term funds to invest, or they may be parties who want to use the security taken as collateral to be used for their own need. As it is clear from the above explanation there can be two motives for entering into repo

- Raising funds for short-term investment
- To obtain a particular security for a short term use

In the latter case, the security is called a **special security** and is special to the lender of the funds. In the former case, it is called general collateral (GC) which the lender keeps in order to secure his investment.

Interest rates payable on special repos are usually lower than those payable on GC repos. This is because a party reverse reposing (i.e. seeing the agreement from the lender's side) will accept a reduced interest rate on its funds as it had used the special security for its own use. Pricing of either type of deal discussed depends upon the needs of the parties doing repo and reverse repo.

The interest rates of repos do not depend upon the respective counterparties' credit qualities as they are like secured loans and if the party defaults then the collateral will cover the risk of the lender. GC repo rates or simply **repo rates** are benchmark short-term interest rates that are widely quoted in the marketplace.

Repo used for hedging

The main purpose of repo transactions is that they are used as hedging tools. Repos are used to investing surplus money for a short-term, or borrow without making changes to the original portfolio.

The Repo rate is usually lower than the yield rate of the bonds, but they are very liquid. And they also have very little credit risk because the collateral is usually high value securities.

Hedging with repos allows shorting of bonds that they do not own and going long (buying) the bonds that they want to buy for a short period. For example, an investor who thinks that the interest rates are going to fall would like to buy bonds now and sell them later when the prices rise. He enters into a repo over securities that are worth 10 million USD, with the promise to buy them back at 11 million in a month. He can now buy other bonds say at $100 a bond and sell them at the end of the month at $120 a bond. He has made a profit of $ 2 million in the transaction; even after he pays $ 1 million for the repo, he still has $1 million as profit, without changing his original portfolio. This is the advantage of repos; they allow the investors to make money without making changes to the original portfolio.

Reverse repos are equally useful for those with surplus funds, entering into a reverse repo would give them more liquidity and income at nearly no risk.

8.4 Government Securities

To fund its operations the government issues several types of securities. All these securities are issued by the Reserve Bank of India on behalf of the Government of India, in lieu of the central Governments market borrowing Programme. All of these securities are backed by the government. Such securities are classified into two categories i.e., marketable and non-marketable. Marketable securities can be bought and sold in the open market/secondary markets, and the prices of these securities rise and fall depending on the market conditions. On the other hand non-marketable securities cannot be traded in the open market and can be only redeemed by the government.

Government securities are of following types: Dated securities, zero coupon bonds, partly paid stock, floating rate bonds, bonds with call or put options, capital indexed bonds.
The term government securities encompasses all bonds and treasury bills issued by the Central Government, State Governments, and other entities like corporations, municipal authorities and companies wholly owned by the government for the purpose of raising funds from the public. These securities are usually referred to as 'gilt-edged' securities as repayments of principal as well as interest are totally secured. The Central Government securities are considered as safest claims.

a) Dated Securities

Dated securities are generally fixed maturity and fixed coupon securities usually carrying semi-annual coupon. These are called dated securities because these are identified by their date of maturity and the coupon, e.g., 11.03% GOI 2012 is a Central Government security maturing in 2012, which carries a coupon of 11.03% payable half yearly. The key features of these securities are:

- They are issued at face value.
- Coupon or interest rate is fixed at the time of issuance, and remains constant till redemption of the security.
- The tenor of the security is also fixed.
- Interest /Coupon payment is made on a half yearly basis on its face value.
- The security is redeemed at par (face value) on its maturity date.

b) Zero Coupon bonds

These bonds are issued at discount to face value and redeemed at par. These were issued first on January 19, 1994 and were followed by two subsequent issues in 1994-95 and 1995-96 respectively. The key features of these securities are:

- They are issued at a discount to the face value.
- The tenor of the security is fixed.
- The securities do not carry any coupon or interest rate
- The difference between the issue price (discounted price) and face value is the return on this security.
- The security is redeemed at par (face value) on its maturity date.

c) Partly Paid Stock

It is a stock where payment of principal amount is made in installments over a given time frame. It meets the needs of investors with regular flow of funds and the need of Government when it does not need funds immediately. The first issue of such stock of eight year maturity was made on November 15, 1994 for Rs. 2000 crore. Such stocks have been issued a few more times thereafter. The key features of these securities are:

- They are issued at face value, but this amount is paid in installments over a specified period.
- Coupon or interest rate is fixed at the time of issuance, and remains constant till redemption of the security.
- The tenor of the security is also fixed.
- Interest /Coupon payment is made on a half yearly basis on its face value.
- The security is redeemed at par (face value) on its maturity date.

d) Floating Rate Bonds

These bonds are with variable interest rate with a fixed percentage over a benchmark rate. There may be a cap and a floor rate attached thereby fixing a maximum and minimum interest rate payable on it. Floating rate bonds of four year maturity were first issued on September 29, 1995, followed by another issue on December 5, 1995. Recently RBI issued a floating rate bond, the coupon of which is benchmarked against average yield on 364 Days Treasury Bills for last six months. The coupon is reset every six months. The key features of these securities are:

- They are issued at face value.
- Coupon or interest rate is fixed as a percentage over a predefined benchmark rate at the time of issuance. The benchmark rate may be Treasury bill rate, bank rate etc.
- Though the benchmark does not change, the rate of interest may vary according to the change in the benchmark rate till redemption of the security. The tenor of the security is also fixed.
- Interest /Coupon payment is made on a half yearly basis on its face value.
- The security is redeemed at par (face value) on its maturity date.

e) Bonds with Call/Put Option

First time in the history of Government Securities market RBI issued a bond with call and put option this year. This bond is due for redemption in 2012 and carries a coupon of 6.72%. However the bond has call and put option after five years i.e. in year 2007. In other words it means that holder of bond can sell back (put option) bond to Government in 2007 or Government can buy back (call option) bond from holder in 2007. This bond has been priced in line with 5 year bonds.

Capital indexed Bonds: In these bonds interest rate is a fixed percentage over the wholesale price index. These provide investors with an effective hedge against inflation. These bonds were floated on December 29, 1997 on tap basis. They were of five year maturity with a coupon rate of 6 per cent over the wholesale price index. The principal redemption is linked to the Wholesale Price Index. The key features of these securities are:

- They are issued at face value.

- Coupon or interest rate is fixed as a percentage over the wholesale price index at the time of issuance. Therefore the actual amount of interest paid varies according to the change in the Wholesale Price Index.
- The tenor of the security is fixed.
- Interest /Coupon payment is made on a half yearly basis on its face value.
- The principal redemption is linked to the Wholesale Price Index.

(Source: http://www.pnbgilts.com/gsec1.asp)

The following are the instruments that are issued by most governments across the world. This is not a complete or detailed list, but it covers the important and popular securities.

SAVINGS BONDS

These are non-marketable securities for the investors who want a marginal return and these securities can be purchased with only a few dollars. Depending on their issued year, these securities have different maturity periods/cycles. Interest on savings bonds is compounded semiannually and they can be redeemed at any time after the first six month of purchase. The interest rate on these bonds is changed every May and November based on either current market rates or inflation. They continue collecting interest for a period for several years until reaching final maturity. At maturity they stop collecting interest.

a) Treasury Bills

Treasury bills (T-bills) offer short-term investment opportunities, generally up to one year. They are thus useful in managing short-term liquidity. At present, the Government of India issue three types of T-bills through auctions, namely, 91-day, 182-day and 3664-day. The State Government does not issue any T-bills. These are available for a minimum amount of Rs. 25, 000 and in multiples of Rs. 25, 000. They are issued at a discount and are redeemed at par.

Treasury bills are short-term US Treasury securities having maturity periods of three months, six months, or one year and issued in denominations of $10,000 to $1 million. T-bills are sold at a discount i.e. investors purchase a bill at a price lower than its face value (for example, the investor might buy a $10,000 bill for $8,700). The return is the difference between the price paid and the amount received when the bill matures (if held till maturity, the return on the T-bill in the example used would be $1300).

b) Treasury Notes

These are intermediate-term securities having a maturity of one to ten years and issued in denominations of $1,000 or more. Notes pay interest (coupon payments) semiannually, and the principal is payable at maturity. The treasury notes can be purchased from the US Government or from the banks. The income from the treasury notes is not taxable at state level.

c) Treasury Bonds

These are long-term securities having maturities of 10 years or longer and issued in denominations of $1,000 or more. Bonds pay interest (coupon payments) semiannually, and the principal is payable at maturity. The income from these bonds is taxable at the federal level.

Sample US Treasury Bond Quote

CUSIP: 912810DN5	Callable: 11/09@100
Type: Treasury	S&P / Moody: AAA / Aaa
Coupon: 11.75	Frequency: Semi-annual
Maturity: 11/15/2014	First Coupon: 05/15/1985
Bid Price: 135.754	Bond Settlement: 02/28/2000
Bid Yield to Maturity: 7.655	Next Coupon: 05/15/2000
Offer Price: 136.254	Dated: 11/15/1984
Offer Yield to Maturity: 7.609	Last Coupon: 05/15/2014

Table 1.1: List of US Treasury Bond Quote

d) Inflation-Indexed Notes

These are newly introduced securities with 10-year maturities and are introduced to offset inflation devaluation effect on the investment. Interest payments are made semiannually, and the principal is payable at maturity. The difference here is that the interest payments and the final principle payment are adjusted for inflation, sheltering the investor from the ravages of inflation.

e) Inflation Protection Securities (IPS)

These are issued for various maturities up to 30 years. They have a fixed coupon rate (which is usually lower than a comparable treasury bond), but the principal is increased annually according to the inflation in the domestic economy. Both, the coupon rate and the principal for IPS vary with Consumer price index and thus the appeal to risk adverse investors who seek protection from inflation.

Interest payments on Treasury notes and bonds are referred to as coupon payments, since in the past the buyer of these instruments was given a coupon book with each coupon representing a particular interest payment. Every time the owner was to collect the interest payment, he/she would tear out the specific coupon and present it to his/her bank. Today this procedure is automated and handled electronically, but it is still referred to as coupon payment.

Interest payments on government securities are subject to federal tax but are exempt from state and local taxes. **The bonds issued by the British are called Gilts**. They are mainly Straights (normal fixed coupon bonds), Convertibles (bonds which can be converted into bonds of longer maturity, they cannot be converted into equity), Index-linked (like the TIPS in the US) and Perpetual (They have no maturity, just a coupon).

CLASSIFICATION OF GOVERNMENT SECURITIES

Depending upon maturities, securities are classified as

- **Long dated Securities**: securities having maturities exceeding 10 years
- **Medium dated Securities**: Securities having maturities from 5 to 10 years
- **Short dated Securities**: Securities which mature within 5 years

Depending upon issuing body, securities are bifurcated into five types viz.

- Central Government Securities
- State Government securities

- Securities guaranteed by Central Government for All India Financial Institutions like IDBI, ICICI, and IFCI etc.
- Securities guaranteed by State Government for state institutions like State Electricity Boards and Housing Boards.
- Treasury bills issued by RBI

Government Securities can be held in three forms viz.

I. Stock Certificates

II. Promissory Notes

III Bearer Bonds

Stock Certificates: When public debt is issued in form of stock, the owner gets a certificate specifying that he is a registered holder in the book of the Public Debt office. The Certificate indicates the interest rate, interest due dates and face value of the stock. A stock certificate is not transferable by endorsement.

Promissory Notes: Promissory Notes contain a promise by the President of India, or the Governor of the state for payment to the holder the consideration along with interest. These are negotiable instruments payable to the order of specified persons and transferable by endorsement made in the boxes printed on the reverse of the notes.

Bearer Bonds: Bearer Bonds certify the bearer for entitlement to the specific sum along with interest payable by the interest warrants attached along with the bonds. Such bonds are transferable by mere physical delivery.

Some useful terms

Repo rate: The rate at which RBI lends money to the banks (4.75% at present). RBI increases this rate when it wants the money (loans and borrowings of the common man) to become costlier with an aim to reduce inflation (excess money in the system). (The rate at which banks borrow from RBI)

Reverse Repo rate: The rate (3.25 % at present) at which banks park their money with RBI for short term by purchasing government bonds. (The rate at which RBI borrows from banks). This is the rate the banks use to decide the rate at which they lend money to the borrowers (PLR: Prime lending rate).

LAF: Liquidity adjustment facility of the RBI through which it matches the day to day liquidity mismatch through the repo and the reverse repo rates.

MSS: Market stabilization scheme was launched in 2004 to mop up the excess liquidity in the market due to the huge inflow of foreign funds in to the domestic market. Under this scheme the RBI sucks liquidity by issuing dated bonds and T-bills. Both LAF and MSS go hand in hand when the economy is in the inflationary phase. The selling of MSS bonds to soak up liquidity is called Sterilization.

Summary

- This session talked about the various types of markets dealing with financial instruments, their functioning, the differences of their trading and the various instruments which trade in these markets.
- This session also gives an overview of the various government instruments traded in the market. How these instruments differ from each other and their payoffs have also been discussed.
- The session also covers repo market and the functioning and uses of the repo market. It also gives the detailed working of the repo and its usage to maintain the liquidity in the market.
- The government securities covered under this section are:
    - Dated securities
    - Zero coupon bonds
    - Partly paid stock
    - Floating rate bonds
    - Bonds with call/put options
    - Capital indexed bonds.
- The other popular bonds issued by government that are discussed in this chapter are:
    - Savings Bonds
    - Treasury Bills
    - Treasury Notes
    - Treasury Bonds
    - Inflation-Indexed Notes
    - Inflation Protection Securities

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