FM Unit - 2

[#] Financial Markets:-

1] A financial market is a word that describes a marketplace where bonds, equity securities, currencies are traded.
2] Five financial markets do a security business of trillions of dollars daily, and some are small-scale with less activity.
3] These are markets where businesses grow their cash, companies ↓e risks and investors make more cash.

⊙ Financial market is further classified in 2 types of market:

1] Money Market 2] Capital market 3] Commodity Market
4] Currency Market 5] Derivative market

☆ Financial Instruments Market Types:-

- Capital Market
  - Debt Market
  - Equity Market
    - Primary Market
    - Derivative Market
    - Secondary Market
- Money Market
  - Treasury Bills
  - Call Money Market
  - Commercial Bills
  - Certificates of Deposits

~~☆ Structure of~~

☆ Structure of Indian Financial Market :-

Indian Financial Market

→ Money Market
- a] Treasury Bills
- b] Call Money
- c] Certificates of Deposit
- d] Commercial Bills
- e] Commercial Paper

→ Capital Market

→ Non-Security Market
- a] Mutual Funds
- b] Bank Deposits
- c] Provident Funds
- d] Small Savings

→ Security Market
- a] Share
- b] Debentures
- c] Commodity
- d] Derivatives.

① Money Market :-

1] Money Market comes under the Financial market. The money market refers to trading in very short-term debt investments from 1 to 90 days.

2] It is regulated by the RBI (reserve bank of India). It is the wholesale market the transaction volume in this market is large.

3] The securities are highly liquid in nature and can be readily converted to cash. The transaction cost is also the minimum.

☆ Financial Instrument belongs to money market :

• Money Market (Short-Term Financial Instruments) :

1] It means a ready market or a short-term market where securities are brought or sold only for a very short duration.

2] The tenure usually does not exceed one year thus is considered to be an equivalent to cash only.

3] The securities are highly liquid in nature and can be readily converted to cash. The transaction cost is also the minimum.

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4] The short-term financial instruments include the instruments which are of less than one year.
5] The various types of securities are T-bills and commercial paper.
6] The different kinds of cash can be deposits, certificate of deposit.

i] Treasury Bills:
1] Treasury Bills show the responsibility of the Government of India.
2] It is basically 91 days and 364 days.
3] They are given to the customers on the auction basis every week which has certain small denominations which are issued by the Reserve Bank of India.
4] It does not have any specific interest rate so they are sold on discount or are redeemed at par.

ii] Commercial Paper (CP):
1] A commercial paper is an unsecured promissory note and money market instrument, issued by large corporate houses for raising funds with a view to meeting their short-term debt obligations such as payroll.
2] CP is not secured by collateral security.
3] It is supported by an issuing bank or company who promises to pay the face value at the maturity date indicated on the note, as it is an unsecured instrument, only the organizations with exceptional credit ranges are capable of issuing their commercial paper at an economical place. 4] The maturity period of CP ranges b/w 15 days and one year.

iii] Certificates of Deposit (CD):
1] CD is also a money market instrument issued by banks to the depositors, in the form of a certificate showing the existence of such a deposit with them. 2] These certificates are in turn traded by the depositors (when such a need arises) between their business associates.

3] The price of CD depends on a] Rate of interest available on the Bank deposit (which is fixed), and b] Rate of interest prevailing in the market at that particular time.

iv] Letter of Credit (LC):
1] Letter of Credit (LC) is a form of bank guarantee.
2] It is an arrangement, under which a bank helps its customer for obtain credit from its (customer's) supplies, by undertaking the responsibility to honour the commitment of its customer, in case of the customer's inability to do so.
3] LCs is opened by banks in respect of specific transactions entered into by their customers.

v] Call Money: 1] Call Money is money borrowed on demand for a very short-term. 2] It is issued only for one day. 3] It needs when a sudden demand for funds is required.

vi] Commodity Bills: 1] A commercial or bill of exchange bill arises out of a genuine trade transaction. 2] It is high liquidity and has low risk. 3] It varies from 7 days to one year.

☆ Types of financial Markets:-

1] Money Market: Money markets provide short term debt financing and investment options.

2] Capital Market:
a] Stock Market: A place where individual and institutional investors come together to buy and sell shares in a public venue.
b] Bonds Market: Market participants can issue & trade (buy and sell) debt securities like bonds.

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3] Commodity Market: A market that facilitate the trading of commodities like crude oil, pulses, metals etc.

4] Forex Market: The most liquid financial market where investors trade in foreign currencies.

5] Derivatives Market: A financial market for trading of derivatives, financial instruments like futures contracts or options, which are derived from other forms of assets.

#② Capital Market:

1] A capital market is a place that allows the trading of funding instruments such as shares, debentures, debt instruments, bonds, etc.
2] It is a source for raising funds for individuals, firms and governments.
3] The securities exchanged here would typically be a long-term investment with over a year ~~back~~ lock-in period. On the other hand, short-term investment are usually found in the money market.
4] It deals with medium-term and long-term instruments.
5] It is regulated by the SEBI (Securities and Exchange Board of India)
6] Capital markets are composed of primary and secondary markets.

☆ a] Primary Market:

1] The primary market is for trading freshly issued securities, i.e., first-time trading. It enables an initial public offering. It is also known as the new issues market.
2] Here, companies raise funds with the help of preferential allotment, rights issue, electronic IPOs, or the pre-selected issue of securities or private placement.

3] Usually, like an investment bank, the intermediary attaches an initial price to the shares. Once the sale materializes, firms take their shares to the stock exchange to facilitate trading b/w diff. investors.

☆ ⓑ Secondary Market:

1] The trading of old securities occurs in the secondary market, which occurs after transacting in the primary market.
2] Both stock markets and over-the-counter trades come under the secondary market. We also call this market the stock market or aftermarket.
3] Examples of secondary markets are London Stock Exchanges, the New York Stock Exchange, NASDAQ, NSE and BSE etc.

#③ Derivative Market:

1] Derivative instruments are financial instruments that have values determined from underlying assets, such as resources, currency, bonds, stocks and stock indexes.
2] The five most common examples of derivative instruments are synthetic agreements, forwards, futures, options and swaps.

①. Synthetic Agreement for Foreign Exchange (SAFE): A SAFE occurs in the over-the-counter (OTC) market and is an agreement that guarantees a specified exchange rate during an agreed period of time.

☆ Financial instruments of Derivative market:

1] Forward: A forward is a contract between the 2 parties that involves customizable derivatives in which the exchange occurs at the end of the contract at a specific price.

2] Future: A future is a derivative transaction that provides the exchange of derivatives on a determined future date at a predetermined exchange rate.

3] Options: An option is an agreement b/w 2 parties in which the seller grants the buyer the right to purchase or sell a certain number of derivatives as a predetermined price for a specific period of time.

4] Interest Rate Swap: An interest rate swap is a derivative agreement b/w 2 parties that involves the swapping of interest rates where each party agrees to pay other interest rates on their loans in different currencies.

#④ Foreign Currency Market:

1] Foreign exchange instruments are financial instruments that are represented on the foreign market and primarily consist of currency agreements and derivatives.

2] In terms of currency agreements, they can be broken into 3 categories

3] Spot: A currency agreement in which the actual exchange of currency is no later than the second working day after the original date of the agreement. It is termed "spot" because the currency exchange is done "on the spot" (limited timeframe).

4] Outright Forwards: A currency agreement in which the actual exchange of currency is done "forwardly" and before the actual date of the agreed agreement. It is beneficial in cases of fluctuating exchange rates that change often.

5] Currency Swap: A currency swap refers to the act of simultaneously buying and selling currencies with different specified value dates.

#⑤ Commodity Market:

1] A commodity market is a marketplace for buying, selling and trading raw materials or primary products.
2] Commodities are often split into 2 broad categories: hard and soft commodities.
3] Hard commodities include natural resources that must be mined or extracted - such as gold, rubber and oil, whereas soft commodities are agricultural products or livestock - such as corn, wheat, coffee, sugar, soybeans and pork.

Financial Instruments:-

1] Financial instruments are contracts for monetary assets that can be purchased, traded, created, modified, or settled for. In terms of contracts, there is a contractual obligation between involved parties during a financial instrument transaction.
2] For example, if a company were to pay cash for a bond, another party is obligated to deliver a financial instrument for the transaction to be fully completed. One company is obligated to provide cash, while the other is obligated to provide the bond.
3] Basic examples of financial instruments are cheques, bonds, securities
4] There are typically 3 types of financial instruments: cash instruments, derivative instruments and foreign exchange instruments.

☆ Types of Financial Instruments:-

1] Capital Market Instruments

- Equity Securities
  - Equity Shares
  - Preference Shares
- Debt Securities
  - Debentures.
  - Bonds

2] Commodity Trading -

Hard Commodities	Soft Commodities
a] Precious Metals	a] Grain b] Sugar
b] Oil	c] Wheat d] Corn
c] Natural Gas	e] Coffee

3] ~~Derivat~~ Money Market Instruments:-
a] Call Money b] Treasury bill c] Commercial Paper
d] Certificate of Deposit e] Trade bill

#] Sources of Finance:-

#1] Equities:

1] The securities market has 2 interdependent and inseperable segments, the new issues (primary) market and the stock (secondary) market.
2] The primary market provides the channel for creation and sale of new securities, while the secondary market deals in securities previously issued.
3] The stock market or equities market is where listed securities are traded in the secondary market.
4] Currently more than 1300 securities are available for trading on the Exchange.
5] Equity Market: It comprises the equity shares of the company. Equity shares are further classified in 2 categories:
a] Primary Market: Where the shares are being sold for the very first time, i.e., Initial Public Offer (IPO) and right issues.
b] Secondary Market: Where the existing shares are brought or sold, after they were originally issued to the public. These shares are listed on the stock exchange through which they can be traded.

☆ Broadly, there are 2 types of shares - Equity shares and preference shares

☆A] Equity Shares:

1] Equity Shares are also referred to as ordinary shares. They are one of the most common kinds of shares. These stocks are documents that give investors ownership rights of the company.

2] Equity shareholders bear the highest risk.

3] Owners of these shares have the right to vote on various company matters.

4] Equity shares are also transferable and the dividend paid is a proportion of profit. One thing to note, equity shareholders are not entitled to a fixed dividend.

5] The liability of an equity shareholder is limited to the amount of their investment. However, there are no preferential rights in holding.

Equity Shares are classified as per the type of share capital-

1] Authorized Share capital: This is the maximum amount of capital a company can issue. It can be ?ed from time to time. For this, a company needs to conform to some formalities and also pay required fees to legal entities.

2] Issued share capital: This is the portion of authorised capital which a company offers to its investors.

3] Subscribed share capital: This refers to the portion of issued capital upon which investor's accept and agree,

4] Paid-up capital: This refers to the portion of the subscribed capital for which the investors pay. Since most companies accept the entire subscription amount at one goes, issued, subscribed and paid capital are the same thing.

There are a few other types of shares-

1] Right share: These are the kinds of shares a company issues to its existing investors. Such stocks are issued to protect the ~~over~~ ownership rights of existing shareholders.

2] Bonus Share: Sometimes, companies may issue shares to their shareholders as a dividend. Such stocks are called bonus shares.
3] Sweat equity share: When employees or directors perform their role exceptionally well, sweat equity shares are issued to reward them.

B] Preference Shares:-

1] When a company is liquidated, the shareholders who hold preference shares are paid off first.
2] They also have the right to receive profits of the company before the ordinary shareholders.

a] Cumulative and non-cumulative preference shares: 1] In the case of cumulative preference share, when the company does not declare dividends for a particular year, it is carried forward and accumulated. When the company makes profits in the future, these accumulated dividends are paid first. 2] In case of non-cumulative preference shares, dividends do not get accumulated, which means there are no future profits, no dividends are paid.

b] Participating and non-participating preference shares: 1] Participating shareholders have the right to participate in remaining profits after the dividend has been paid out to equity shareholders. So in years where the company has made more profits, these shareholders are entitled to get dividends over and above the fixed dividend.
2] Holders of non-participating preference shares do not have a right to participate in the profits after the equity shareholders have been paid. So in case a company makes any surplus profit, they will not get any additional dividends. They will only receive their fixed share of dividends every year.

c] Convertible and non-convertible preference shares: 1] Here, the shareholders have an option or right to convert these shares into ordinary equity shares. For this, specific terms and conditions need to be met. 2] Non-convertible preference shares do not have a right to be converted into equity shares.

d] Redeemable and irredeemable preference shares: Redeemable preference shares can be claimed or repurchased by the issuing company. This can happen at a predetermined price and at a predetermined time. These do not have a maturity date which means these types of shares are perpetual. So companies are not bound to pay any amount after a fixed period.

2] Debt Segment

Under the debt segment mainly it belongs to debenture and bonds.

☆A] Debentures:-

1] The Wholesale Debt Market (WDM) segment of the Exchange commenced operations on June 30, 1994.
2] This provided the first formal screen-based trading facility for the debt market in the country.
3] It has now been merged under the New Debt Market as the Negotiated Trade Reporting Platform.
4] A debenture is a type of debt instrument that is not backed by any collateral and usually has a term greater than 10 years.
5] Debentures are backed only by the credit worthiness and reputation of the issuer.
6] Both corporations and governments frequently issue debentures to raise capital or funds.
7] Some debentures can convert to equity shares while others cannot.

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⊙ Types of Debentures:

1] A debenture is a written tool accepting a debt under the general authentication of the enterprise.

2] It comprises an agreement for repayment of principal after a particular period or at intermissions or at the option of the enterprise and for payment of interest at a fixed rate due to, usually either yearly or half-yearly on fixed dates.

3] According to the section 2(30) of The Companies Act, 2013 "Debenture" comprises of - Debenture Inventory, Bonds any other securities of an enterprise whether comprising a charge on the assets of the enterprise or not.

4] The debenture categorisation depends on their redemption, tenure, convertibility, security, mode of redemption, type of interest rate, coupon rate, demonstrability, etc.

1] From the point of view of security:

a] Secured Debentures: Secured debentures are that kind of debentures where a charge is being established on the properties or assets of the enterprise for the purpose of any payment.

b] Unsecured Debentures: They do not have a particular charge on the assets of the enterprise.

2] From the point of view of tenure:

a] Redeemable Debentures: These debentures are due on the cessation of the time frame either in a lump-sum or in installments during the lifetime of the enterprise.

b] Irredeemable Debentures: These debentures are also called as perpetual debentures as the company doesn't give any attempt for the repayment of money ~~required~~ acquired or borrowed by circulating such debentures.

3] From the point of convertibility:
a] Convertible Debentures: Debentures which are changeable to equity shares or in any other security either at the choice of the enterprise or the debenture holders are called convertible debentures.
b] Non-convertible Debentures: The debentures which can't be changed into shares or in other securities are called non-convertible debentures.

4] From the Coupon rate point of view:
a] Specific Coupon rate Debentures: Such debentures are circulated with a mentioned rate of interest, and it is known as the coupon rate.
b] Zero Coupon rate Debentures: These debentures don't normally carry a particular rate of interest.

5] From the view point of Registration:
a] Registered Debentures: These debentures are such debentures within which all details comprising addresses, names and particulars of holding of the debenture holders are filed in a register kept by the enterprise.
b] Bearer Debentures: These debentures are debentures which can be transferred by way of delivery and the company does not keep any record of the debenture holders. ~~interest~~

☆B] Bonds:

1] A bond is a fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental).
2] A bond could be thought of as an I.O.U. b/w the lender and borrower that includes the details of the loan and its payments.
3] Bonds are used by companies, municipalities, states and sovereign governments to finance projects and operations. Owners of bonds are debt holders, or creditors of the issuer.

4] Bond details include the end date when the principal of the loan is due to be paid to the bond owner and usually include the terms for variable or fixed interest payments made by the borrower.

5] Corporate bonds are debt securities issued by private and public corporations. Companies issue corporate bonds to raise money for a variety of purposes, such as building a new plant, purchasing equipment, or growing the business. When one buys a corporate bond, one lends money to the "issuer", the company that issues the bond. In exchange, the company promises to return the money, also known as a "principal", on a specified maturity date. Until that date, the company usually pays you a stated rate of interest, generally semi-annually.

7] While a corporate bond gives an IOU from the company, it does not have an ownership interest in the issuing company, unlike when one purchases the company's equity stock.

- Characteristics of Bonds:

Most bonds share common basic characteristics including:

1] Face value (par value) is the money amount the bond will be worth at maturity; it is also the reference amount the bond issuer uses when calculating interest payments. For e.g., say an investor purchases a bond at a premium of $1,090 and another investor buys the same bond later when it is trading at a discount for $980. When the bond matures, both investors will receive the $1,000 face value of the bond.

2] The coupon rate is the rate of interest the bond issuer will pay on the face value of the bond, expressed as a percentage. For e.g., a 5% coupon rate means that bondholders will receive 5% × $1,000 face value = $50 every year.

3] Coupon dates are the dates on which the bond issuer will make interest payments. Payments can be made in any interval, but the standard is semi-annual payments.

4] The maturity date is the date on which the bond will mature and the bond issuer will pay the bondholder the face value of the bond.

5] The issue price is the price at which the bond issuer originally sells the bonds. In many cases, bonds are issued at par.

⊙ Types of bonds:

1] Convertible Bonds: They are debt instruments with an embedded option that allows bondholders to convert their debt into stock (equity) at some point, depending on certain conditions like the share price.

2] Callable Bonds: They also have an embedded option, but it is different that what is found in a convertible bond. A callable bond is one that can be "called" back by the company before it matures.

3] Puttable Bonds: A puttable bond allows the bondholders to put or sell the bond back to the company before it has matured.

4] Plain Vanilla Bonds: It is a bond without unusual features; it is one of the simplest forms of bonds with a fixed coupon and a defined maturity and is usually issued and redeemed at face value.

5] Zero-Coupon Bonds: A zero coupon bond is a type of bond with no coupon payments.

6] Deferred Coupon Bonds: It is a blend of coupon-bearing bond and a zero-coupon bond.

~~7~~8] Step-up Bonds: The step up bonds are where the coupon usually steps up after a certain period.

8] Step-Down Bonds: These are the bonds where the coupon usually steps down after a certain period.

#4] Retained Earnings:

1] Retained Earnings (RE) are the accumulated portion of a business's profits that are not distributed as dividends to shareholders but instead are reserved for reinvestment back into the business.
2] Normally, these funds are used for working capital and fixed asset purchases (capital expenditures) or alloted for paying off debt obligations.

#5] Term Loan:

1] A term loan provides borrowers with a lump sum of cash upfront in exchange for specific borrowing terms.
2] Term loans are normally meant for established small businesses with sound financial statements.
3] In exchange for a specified amount of cash, the borrower agrees to a certain repayment schedule with a fixed or floating interest rate.
4] Term loans may require substantial down payments to reduce the payment amounts and the total cost of the loan.
~~5] A term loan provides borrowers with~~ 5] Term loans are commonly
~~5] Borrowers~~ used by small businesses to purchase fixed assets, such as equipment or a new building.
6] Borrowers prefer term loans because they offer more flexibility and lower interest rates.
7] Short and intermediate-term loans may require balloon payments while long-term facilities come with fixed payments.

☆ Types of Term Loans:

Term loans come in several variables, usually reflecting the lifespan of the loan. These include:

1] Short-term loans: These types of term loans are usually offered to firms that don't qualify for a line of credit. They generally run less than a year, though they can also refer to a loan of upto 18 months.

2] Intermediate-term loans: These loans generally run between one to three years and are paid in monthly installments from a company's cash flow.

3] Long-term loans: These loans last anywhere between 3 to 25 years. They use company assets as collateral and require monthly or quarterly payments from profits or cash flow. They limit other financial commitments the company may take on, including other debts, dividends or principals' salaries, and can require an amount of profit set aside specifically for loan repayment.

6] Lease:

Lease is a contract whereby the owner of the asset (lesser) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in written for the payment of rent.

☆ Features of Leasing: -

1] 2 Parties 2] Selection of an asset 3] Purchase of an asset
4] Use of the asset 5] Rentals and installations payments.
6] Recovering the cost of an asset. 7] Option of acquiring ownership of the asset. 8] A lease is a contractual agreement in which:
a] A party owning an asset i.e. lesser b] Provides an asset for use to another party i.e. lesse c] For an agreed period of time i.e. lease period d] For a consideration i.e. lease rentals.

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1] Lease financing is one of the important sources of medium and long-term financing where the owner of an asset gives another person, the right to use that asset against periodical payments.
2] The owner of the asset is known as lessor and the user is called lessee.
3] The periodical payment made by the lessee to the lessor is known as lease rental.
4] Under lease financing, lessee is given the right to use the asset but the ownership lies with the lessor and at the end of the lease contract, the asset is returned to the lessor or an option is given to the lessee either to purchase the asset or to renew the lease agreement.
5] Marketing of lease is done by financing many kinds of assets to consumers as well as business which includes: a] Plant & machinery b] Business cars c] Commercial vehicles d] Agricultural equipments e] Hotel equipments f] Medical and dental equipments g] Computers including software packages h] Office equipments

☆ Types of Lease:

1] Financial Lease: 1] Also known as Full Payout Lease, is a type of lease wherein the lessor transfers substantially all the risks and rewards related to the asset to the lessee. 2] Generally, the ownership is transferred to the lessee at the end of the economic life of the asset. 3] The lease term is spread over the major part of the asset life. 4] Here, a lessor is only a financier. 5] An e.g. of a finance lease is big industrial equipment.
2] Operating Lease: 1] In an operating lease, risk and rewards are not transferred completely to the lessee. 2] The term of a lease is very small compared to the finance lease. 3] The lessor depends on many different lessees for recovering his cost. 4] Ownership along with its risks and rewards lies with the lessor. 5] Here, a lessor is not only acting as a financier but he also provides additional services required in the course of using the asset or equipment. 6] E.g: music system