Constituents of a Financial System

Surplus Units
Deficit Units
Financial Markets
Financial Intermediaries

Capital Markets - Ia

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Financial System

Surplus Units: Households, in the aggregate
Deficit Units: Governments and Corporations

Financial Markets: Vast forum where surplus units, deficit units and financial intermediaries forge linkages through financial instruments

Financial Intermediaries: Intermediate, i.e., borrow from surplus units and lend to deficit units at terms acceptable to both sides

Financial Markets

- **Money Market**
- Funds are borrowed or lent for periods less than one year
- Facilitates adjustments to short-term liquidity positions

- **Capital Market**
- Funds are borrowed or lent for periods exceeding one year
- Typically associated with capital expenditures

Other markets

- Foreign exchange markets: Spot and forward transactions

- Derivatives Markets: Standardized contracts at exchanges, e.g., Options and Futures, and customized contracts over-the-counter, e.g., forwards and swaps

Money Market and Capital Market

- Both Money Market and Capital Market have a primary and a secondary segment.
- The primary segment refers to transactions by which securities are originated.
- The secondary segment refers to trading in securities, which were issued earlier. Thus, Stock Markets are a part of the secondary segment of the Capital Market
- A way to distinguish between the two is by asking: Who is the seller?

Participants

- Money Market
- Government, banks and financially sound companies

- Capital Market
- Government, companies, financial intermediaries and investors in general

Financial Instruments

- **Money Market (maturity**
- **< 1 year)**

- Call and Notice Money
- Treasury Bill
- Repos
- Commercial Paper
- Certificate of Deposit
- Inter-bank Term Money
- Inter-bank Participation Certificate
- Bill of Exchange
- ICDs / FCDs

- **Capital Market (maturity**
- **> 1 year)**

- Government Securities (“Gilts)
- Corporate debentures/bonds
- Preference shares
- Equity shares
- Warrants (sweetener)

GDR/ADR, Foreign Bonds, Foreign Currency Convertible Bonds

Other long-term sources

- Leasing (and Hire-purchase too) are important long-term sources of funds

- Forms of Leasing:

Direct Lease: Financial and Operating Lease

Sale and Leaseback

Features of some capital market instruments

- **Debentures / Bonds**

- Long-term debt instrument
- Coupon: Fixed or floating
- Yield: the return to an investor and the actual cost to the issuer
- Life: Certain
- Voting rights: No
- Priority of claim on earnings and assets
- Deed of trust, i.e., indenture
- Less expensive source of funds, because of lower risk to investors and also the tax shield
- A good rating is desirable

Equity shares

- Represent a residual ownership interest
- Dividends may not be paid
- Bear voting rights
- Most expensive source of finance (high risk and no tax shield)
- Equity capital facilitates borrowing

Preference shares

- Stated dividend
- Ordinarily, no voting right
- Dividend may be missed
- Subordinate to debentures

Types of debentures / bonds

- Floating-rate (Indexed)
- Deep discount including zero-coupon
- Convertible
- Revenue
- Income
- Participating
- Bull and Bear

What accounts for yield differentials among bond issues?

- Default Risk (Indicator: Credit Rating)
- Maturity
- Call proviso
- Convertibility
- Marketability
- Tax features

Computing the yield to maturity

- A bond with five years to maturity, has a face value of Rs. 100 and an annual coupon of 8%. If the bond is trading at Rs. 92, what is its yield?
- A bond with seven years to maturity has a face value of Rs. 100 and an annual coupon of 10%, paid semi-annually. If the bond is trading at Rs. 106, what is its yield?
- Important: BOND PRICES MOVE INVERSELY TO BOND YIELDS

What are Structured Debt Obligations?

- Debt securities that bear special features which enhance the investment quality of the instruments.

Financial Intermediaries

- Banks
- Term-lending institutions
- Mutual Funds
- Pension and Provident Funds
- Insurance Companies
- Specialized institutions

Investment Policies of Financial Intermediaries

- Banks: prefer liquid assets and hence lend mostly short-term to businesses
- Term-lending institutions: advance loans of around 5-7 years to businesses
- Mutual Funds: invest in a portfolio of assets, depending upon the objective
- Pension Funds: primary vehicle of retirement saving, hence risk-averse
- Insurance Companies: high emphasis on safeguarding principal
- Specialized institutions: cater to a specific segment