2nd SEMESTER (FYUGP)

MDC (PERSONAL FINANCIAL MANAGEMENT)

UNIT 2: FINANCIAL MARKETS AND INSTRUMENTS

Q1. What is a Financial Market?

Answer - A Financial Market is referred to any place or system that provides buyers, sellers and intermediaries the means to trade financial assets such as equities, bonds, equities, currencies and derivatives. It plays a crucial role in allocating limited resources, in the country's economy. It acts as an intermediary between savers and investors by mobilising funds between them. In general, the savers are known as the surplus units and the investors are known as the deficit units.

Q2. State the features of Financial Market.

Answer - Following are some of the features of Financial Market:

a) Financial market involves large volume of transactions on daily basis.

b) Provides liquidity or the quick availability of cash that many businesses require. Investors benefit from liquidity by knowing they may quickly sell their financial assets for cash if necessary or desired.

c) There are various segments in financial market like stock market, forex market, money market, etc.

d) Market is highly volatile in nature. Prices of instrument will change every day, every minute. There is no stability in market and due to this high volatility there is scope for speculation of making quick profit.

e) Market is dominated by intermediaries and private dealers, as without intermediary, no transaction in the financial market can be done.

f) Negative externalities are associated with financial markets. A failure in any one segment of the markets may affect many other segments of the market, including the non-financial markets.

Q3.What is Money Market? State the features of Money Market.

Answer - Money market is the market for short term funds meant for use for a maximum period of one year. Money market ensures short term requirements of cash and the utilization of short term funds. The money market constitutes a major source of working capital finance. It brings together the lenders who have surplus short term investible funds and the borrowers who are in need of short term funds. In this market funds can be borrowed for a short period varying from a day, a week, 9 month, upto one year period against various types of instruments, such as bill of exchange, call money, treasury bills, commercial paper, certificate of deposit, etc.

The features of money market are -

- Short term funds are borrowed and lent.
- Money market is an inter-bank market which matches the deficits and surplus in the financial system.
- The financial assets that are dealt in the money market are close substitute of money which can be readily converted into cash without loss and with minimum transaction cost.
- No fixed place for carrying out operations.
- Dealings may be conducted with or without brokers.
- It is not a single market but comprises several sub-markets such as treasury bill market, commercial bill market, etc.
- The main organizations in the market are RBI, State Government, banks, corporate investors, etc.

Q4. State the prime functions of Money Market.

Answer - The money market contributes to the economic stability and development of a country by providing short- term liquidity to governments, commercial banks, and other large organizations.

The main functions of the money market are:

(a) **Supply Short Term Funds** - Money markets provide short- term funds to various public and private institutions to meet the working capital needs. This is done through direct advances in the form of loans, overdrafts or cash credit and through the discounting of commercial bills or other commercial papers.

(b) **Helps in Financial Mobility -** The money market helps in financial mobility by enabling easy transfer of funds from one sector to the other. Financial mobility is essential for the development of industry and commerce in the economy.

(c) **Encourage Savings and Investments** - Money market provides liquidity and safety of financial assets and thereby encourages savings and investment in these assets. Income in the form of interest encourages people to save more.

(d) **Increasing Capital Formation** - The money market helps to promote capital formation by providing a platform for businesses and individuals to invest their funds in a variety of financial instruments.

(e) **Promote Liquidity and Safety -** This is one of the most important functions of money market, as it provides safety and liquidity of funds. It also encourages saving and investments. These investments instruments have shorter maturity which means they can readily be converted to cash. The money market instruments are issued by entities with good credit score which makes them safe investment option.

(f) **Facilitate Adjustment of Liquidity Position** - Another important function of money market is to help in adjustment of liquidity positions of commercial banks to meet the Cash

Reserve Ratio(CRR) or Statutory Liquidity Ratio (SLR) mandatory requirement as stipulated by the Central Bank.

(g) Support for Government Financing - Governments raise funds for short-term budgetary needs by issuing Treasury bills in the money market. These bills serve as a means for governments to cover temporary deficits, manage cash flow fluctuations, and meet immediate financial obligations. The money market provides a reliable source of funds for governments while offering investors a secure investment option. **Example:** A government needs funds for immediate expenses during a budget shortfall. It issues Treasury bills with a promise to repay the amount after a short period, securing necessary funds quickly and efficiently.

Q5. What are the major instruments of Money Market?

Answer - The Money Market Instruments in India have a maturity period of less than one year. The main money market instruments are as follows:

a) Treasury Bills

b) Commercial Papers

c) Certificates of Deposit (CDs)

d) Call Money

e) Banker's Acceptance

f) Repurchase Agreements (Repo)

These are explained below:

a) Treasury Bills - Treasury Bills or T-Bills are short-term debt money market instruments introduced in 1917. The RBI issues T-Bills on behalf of the Government of India as a promissory note with guaranteed repayment at a later date. Funds collected through such tools are typically used to meet short term requirements of the government

to reduce the overall fiscal deficit of a country. The treasury bills are available at a discount to their original value, and the buyer gets the amount equivalent to the face value on maturity. T-Bills are zero coupon securities as the buyer does not receive any interest. You can buy it in three tenors, 91 days, 182 days, and 364 days.

b) **Commercial Papers -** The RBI introduced commercial papers (CPs) in 1990 to diversify the sources of short-term borrowings for corporate borrowers and to provide investors with a new instrument. It is an unsecured money market instrument in the form of a promissory note issued by only large and credit worthy companies. It is negotiable and transferable by endorsement. The funds raised through commercial paper are used to fulfill seasonal and working capital needs. Commercial paper is issued at discount and redeemed at par. One can buy commercial paper at a discount. The return on CPs equals the difference between the purchase price and the face value. CPs is issued for varied tenure ranging from 15 days to 364 days. It is also called 'Bridge Finance'. For example, a company wants to raise long term funds and for this purpose it will have to incur floatation costs. These expenses may be met through commercial paper.

c) **Certificates of Deposit (CDs) –** Another component of the money market is Certificates of Deposit. It was first used in 1989 to increase the range of money market instruments in India. CDs can be issued only by Scheduled Commercial Banks, Regional Rural Banks and Small Finance Banks when they have a tight liquidity position because of slow growth of bank deposit but the demand for credit is high. This instrument offers greater flexibility to investors to utilize their funds. These are unsecured and negotiable. The RBI has issued guidelines for CDs and updates them routinely. Companies, corporations, individuals, etc., can purchase them. The tenure of CDs ranges from seven days to one year.

d) **Call Money** – Call money market refers to the market for very short period. Bill brokers and dealers in stock exchange usually borrow money at call from the commercial banks. These loans are given for a very short period with a maturity period varying from 1 day to 14 days, but more often from day-to –day or for overnight only i.e. 24 hours.

There is no demand for collateral securities against call money. They possess high liquidity, the borrowers are required to pay the loan as and when asked for i.e. at a very short notice. It is on account of this reason that these loans are called ‘call money’ or call loans.

e) **<u>Banker’s Acceptance</u> -** Banker’s Acceptance (BA) is probably the oldest money market instrument. It has been in use since the 12th century to facilitate trade. Unlike the other money market instruments, BA is a bank’s obligation to pay an individual account holder. In layman’s words, the bank has to pay a specified amount to the account holder. A bankers acceptance, or BA, is a time draft drawn on and accepted by a bank. Before acceptance, the draft is not an obligation of the bank; it is merely an order by the drawer to the bank to pay a specified sum of money on a specified date to a named person or to the bearer of the draft. Upon acceptance, which occurs when an authorized bank employee stamps the draft "accepted" and signs it, the draft becomes a primary and unconditional liability of the bank. The maturity period falls between 30 days to 180 days. Banker’s Acceptance is often used in trade (particularly when there is import-export of goods involved).

f) **<u>Repurchase Agreements</u> -** Repurchase Agreements, also known as repo, are short-term borrowings in government securities for dealers. In 1992, repo was introduced to improve the economy’s short-term liquidity management and to manage and even out interest rates in the money market. Dealers sell government securities as collateral to investors and then buy them at a higher price the next day. Repurchase Agreements do not have a maximum maturity period, but the minimum is one week. In some repo securities, there is no fixed maturity period, and there can be regular fluctuations in the interest rates contingent on the market conditions. Repurchase Agreements include agency bonds, government bonds, corporate bonds, emerging market bonds, convertible bonds, and supranational bonds.

Q6.What is Capital Market? State the features of Capital Market.

Answer - A capital market is a market for the trading of long-term investments. In other words, it is a marketplace for investments that have a lock-in period greater than a year, or their maturity period is at least more than one year. The capital market involves the sale and purchase of both equity and debt instruments, including equity shares, debentures, preference shares, bonds, zero-coupon bonds, etc. The business enterprises utilize this market to procure finances for long term investments, such as buying plant, machinery, buildings, etc.

The features of Capital Market are –

- Capital market helps the movement of public savings into productive investments. Such movements results in capital formation and economic growth of a country.
- Capital market deals in only long and medium term funds like shares, debentures, loan, etc.
- Capital market reflects the rate of capital growth in the economy. Capital market circulates the funds among different sectors of the economy. It provides the huge fund required for large infrastructure developments in the economy by attracting investments from the public.
- It offers incentives for savings in the form of suitable rates of interest and dividends.
- Capital market includes both primary and secondary markets. Primary market relates to issue of fresh securities in the market and secondary market deals with sale and purchase of existing securities through stock exchange.
- There are a number of intermediaries who help in conducting the transactions in capital market. The purchase and sale of securities takes place through intermediaries which include stock brokers, underwriters, banks, financial institutions, etc.

Q7. Explain the prime functions of Capital Market.

Answer - The capital market plays a significant role in the national economy. It plays a very important role in mobilizing resources and allocating them to productive channels. The main functions of capital market are as follows:

(a) **Helps in raising long-term funds** – Capital market enable corporate, industrial organizations, financial institutions, trusts and the government to get long-term funds from domestic and foreign markets.

(b) **Accelerating the pace of growth** - Easy and smooth availability of funds for medium and long period encourages the entrepreneurs to take profitable ventures/businesses in the field of trade, industry, commerce and even agriculture. It results in the all round economic growth and accelerates the pace of economic development.

(c) **Generating liquidity** - Liquidity means convertibility into cash. Shares of the public companies are transferable i.e., in case of financial requirements these shares can be sold in the stock market and the cash can be obtained. This is how capital market generates liquidity.

(d) **Increase the national income** - Funds flow into the capital market from individuals and financial intermediaries which are absorbed by commerce, industry and government. It thus facilitates the movement of stream of capital to be used more productively and profitability to increase the national income.

(e) **Capital formation** - The capital market provides incentives to savers in the form of interest or dividend to transfer their surplus fund into the deficit units who will invest it in different businesses. The transfer of funds by the surplus units to the deficit units leads to capital formation.

(f) **Productive investment** - The capital market provides a mechanism for those who have surplus money they transfer their savings to those who need funds for productive investments. It diverts resources from wasteful and unproductive channels such as gold, jewelry, conspicuous consumption, etc. to productive investments.

(g) **Stabilization of the value of securities** - A well developed capital market comprising expert banking and non-banking intermediaries brings stability in the value of stocks and securities. It does so by providing capital to the needy at reasonable interest rates and helps in minimizing speculative activities.

Q8. Distinguish between Capital Market and Money Market.

Answer – The difference between Capital Market and Money Market are explained below:

Basis	Capital Market	Money Market
Period of Finance	It provides finance/money for long - term investment.	It provides finance/money for short- term investment.
Instruments traded	The instruments of capital market include equity shares, preference shares, bonds, debentures, etc.	Some of the main instruments used in money market are commercial paper, treasury bills, trade bills, certificate of deposits, etc.
Use of Funds	The finance provided by the capital market may be used both for fixed and working capital.	The finance provided by money market is utilized, usually for working capital.
Liquidity	Mobilisation of resources and effective utilization of resources through lending are its main functions.	Lending and borrowing are its principal functions to facilitate adjustment of liquidity position.
Linkage	It acts as a middleman between the investor and the	It acts as a link between the depositor and the borrower

	borrower for a long-term need.	for a short-term need.
Underwriting	Underwriting is one of its primary activities.	Underwriting is a secondary function.
Involvement of Brokers	The help of brokers is common in capital market.	There is no need of brokers.
Specific location	Transaction takes place through stock exchange situated at a specific place.	There is no formal place for transaction. Most of the transactions are done over the phone.
Risk factor	Due to less liquid nature and long term maturity, the risk is comparatively high.	Since the market is liquid and the maturity