Financial Derivatives

A financial derivative is a financial instrument that is linked to another specific financial instrument, indicator or commodity and through which specific financial risks (such as interest rate risk, foreign exchange risk, equity and commodity price risk) can in their own right, be traded in financial markets. The value of a financial derivative comes from the price of an underlying item such as an asset or index. Financial derivatives can be used for risk management, hedging (protecting) against financial losses on commercial transactions and financial instruments and arbitrage between markets and speculation. There are two distinct classes of financial derivatives — forwards and related instruments, and options. The most common forward instruments are forward contracts, futures contracts, Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRS). Financial derivatives are traded over-the-counter, in which case they are customised and can be purchased from financial institutions or are standardised products which are traded on organized exchanges.

Payment and Settlement Infrastructure

One of the most important functions of the financial system is to ensure safety and efficiency in payments and securities transactions. Financial infrastructure refers to the different systems that provide for the execution of both large-value and small-value payments. Payment and settlement systems enable the transfer of money in the accounts of financial institutions to settle financial obligations between individuals and institutions.

Spanish Method

It would be worthwhile to examine the approaches of the various regulators to housing or mortgage finance. Spain, which follows a rules-based system, has a clearly spelt out mortgage risk policy for its credit institutions. Banco De Espana (BE) lays down that lending policy of credit institutions for mortgage should take into account the repaying capacity of the borrowers and should not just be based on the collateral. BE also emphasizes on the importance of the loan to value (LTV) ratio. It cautions its credit institutions against being too permissive about LTV as this typically increases the expected losses in a mortgage loan portfolio.

The conservatism that insulated Spanish banks from crisis also played its role in keeping the banking system healthy in Canada, which follows a principles-based system of regulation. For example, mortgages with less than a 20 per cent down-payment have to be insured, and most of the securitized mortgage market consists of Canada Mortgage Bonds, which carry a government guarantee. The Canadian central bank also did not allow creation of complex, synthetic securitized instruments involving Canadian mortgage assets.

In India, the Reserve Bank of India (RBI) has strict rules regarding housing finance, specifying the risk weights to be attached to loans extended to borrowers. These risk weights vary according to the LTV ratios. The RBI also specifies the maximum sanctioned amount for LTV ratios as less than or equal to 75 per cent.

UK's System

In the UK, the Financial Services Authority (FSA) follows a principles-based regulation. However, in its proposed reforms for mortgage lending, it has categorically banned certain practices such as self-certified mortgages replacing it with those requiring verification of the income of the borrowers. It also now requires mortgage advisers to be personally accountable to the FSA.

Having realised that non-interventionist principles-based system need not always lead to the desired regulatory outcome, there appears to be a distinct shift in the UK from a non- interventionist stance to a more intrusive one.

The Federal Reserve has also notified a revision in its Regulation Z (which implements the Truth in Lending Act and Home Ownership and Equity Protection Act), prohibiting creditors from making higher-priced mortgage loans based on the "value of the consumer's collateral without regard to the consumer's repayment ability".

Thus, in the case of the US and the UK, at least with respect to mortgage lending, the bias is in favour of a rules-based system. But is this desirable?

One of the biggest criticisms levelled against the rules-based system is that it stifles innovation by being too interfering. In contrast, a principles-based regulation is more accommodative to innovation because it is pliant and flexible. But, as the recent meltdown has shown, while gains from financial innovation benefit a few, the losses affect a greater number through systemic instability. When it comes to a trade-off between profitability and financial stability, the choice is very clear. Financial stability creates conducive atmosphere for profitability and for carrying out banking. Therefore, a rules-based system clearly scores over a principles-based system.

A developing country like India has its own compulsions which make a rules-based system better suited when it comes to meeting our development objectives. For example, with respect to financial inclusion, unless it is specifically laid down that banks must offer

no-frills accounts to their customers with zero or minimum balance and also relax criteria for identification and account opening, the goal of financial inclusion may not be achieved.

Also, there is nothing in the rules-based system that disallows innovation. If that were the case, Indian banks wouldn't have been allowed to offer several products that they now offer. The pace of innovation would be slow but if it ensures financial stability for the system, the trade-off would be well worth it.

Introduction

Financial Market is the interface between a large number of buyers and sellers of the financial products. The prices of the products are fixed by the market forces of demand and supply within the market itself.

The financial market promotes the savings of the economy, providing an effective channel for transmitting the financial policies. Technically speaking, a financial market facilitates:

1. Raising of capital (in the capital markets);
2. Transfer of risk (in the derivatives markets);
3. International trade (in the currency markets)

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Types of Financial Market

A Financial Market can be defined as the market in which financial assets are created or transferred. As against a real transaction that involves exchange of money for real goods or services, a financial transaction involves creation or transfer of a financial asset. Financial Assets or Financial Instruments represent a claim to the payment of a sum of money sometime in the future and/or periodic payment in the form of interest or dividend.

Money Market: The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.

Capital Market: The capital market is designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year.

Forex Market: The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe.

Credit Market: Credit market is a place where banks, FIs and NBFCs Purvey short, medium and long-term loans to corporate and individuals

2.1 Capital Market

The capital market is the market for securities, where companies and governments can raise long-term funds. It is a market in which money is lent for periods longer than a year.

The different types of financial instruments that are traded in the capital markets are equity instruments, credit market instruments, insurance instruments, foreign exchange instruments, hybrid instruments and derivative instruments.

Capital Market consists of primary market and secondary market. In primary market newly issued bonds and stocks are exchanged and in secondary market buying and selling of already existing bonds and stocks take place

Primary Capital Market

The primary capital markets is also called the New Issue Market or NIM. The securities which are introduced in the market are sold for first time to the general public in this market. This market is also known as the long-term debt market as the fund raised from this market provides long-term capital.

The act of selling new issues in the primary capital market follows a particular process. This process requires the involvement of a syndicate of the securities dealers. The dealers who are running the process get a certain amount for as commission. The price of the security offered in the primary capital market includes the dealer, commission also.

Again, if the issue is a primary issue, the investors get the issue directly from the company and no intermediary is needed in the process. For the purpose, the investor needs to send the exact amount of money to the respective company and after receiving the money, the particular company provides the security certificates to the investors.

The primary issues which are offered in the primary capital market provide the essential funds to the companies. These primary issues are used by the companies for the purpose of setting new businesses or to expanding the existing business. At the same time, the funds collected through the primary capital market, are also used for the modernization of the business. At the same time, the primary capital market is also involved in the process of creating capital for the respective economy.

There are three ways of offering new issues in the primary capital market. These are:

Initial Public Offering (IPO): An IPO is the first sale of stock by a private company to the public. IPOs are often issued by smaller, younger companies seeking the capital to expand, but can also be done by large privately owned companies looking to become publicly traded.

In an IPO, the issuer obtains the assistance of an underwriting firm, which helps it determine what type of security to issue (common or preferred), the best offering price and the time to bring it to market.

Preferential Issue: A preferential issue can be defined as an issue of stock available only to designated buyers. These buyers are a select set of people, whether promoters, their relatives, or institutional investors.

One could call it a wholesale equity market since the retail investors or shareholders are not invited to participate.

Rights Issue: The rights issue is a special form of shelf offering or shelf registration for existing Companies. With the issued rights, existing shareholders have the privilege to buy a specified number of new shares from the firm at a specified price within a specified time.

2.1.1 Secondary Capital Market

The secondary capital market deals with those securities that are already issued in an initial public offering in the primary market. Typically, the secondary markets are those where previously issued securities are purchased and sold.

In the secondary capital market, the securities are generally sold by and transferred from one investor to another. Hence, the secondary capital market needs to be highly liquid in nature. A high transparency for the secondary market trading is also required. With the advancement of the technology, the trading concept in secondary market has changed substantially. In the earlier days, the investors needed to meet at fixed place in order to carry out the transactions. But now trading in secondary capital market has become much easier for the investors.

Money Market

A money market can be defined as a market for short-term debt securities with a maturity of one year or less and often 30 days or less. Money market securities are generally very safe investments which return a relatively low interest rate that is most appropriate for temporary cash storage or short-term time horizons.

The money market is better known as a place for large institutions and government to manage their short-term cash needs. However, individual investors have access to the market through a variety of different securities.

2.1.2 Types of Money Market

Money market can be of two types namely organized money market and unorganized money market.

Organised money market: It comprises of commercial banks, financial institutions and all short term asset trading institutions.

Unorganised money market: Along with the organized money market, there exists a very strong unorganised money market, especially in countries that are developing but are still to be developed. In such countries, people and small companies prefer taking loans from relatives, usurers, sahukars, etc, instead of going and applying to organised institutions registered under the monetary authorities.

2.1.3 Money Market Instruments

The money market can be defined as a market for short-term money and financial assets that are near substitutes for money. The term short-term means generally a period up to one year and near substitutes to money is used to denote any financial asset which can be quickly converted into money with minimum transaction cost.

Some of the important money market instruments are briefly discussed below:

1. Call/Notice Money
2. Treasury Bills
3. Term Money
4. Certificate of Deposit
5. Commercial Papers

Let us understand the main instruments of money market by the discussion hereunder:

1. ***Call/Notice Money:*** Call money is the money borrowed or lent on demand for a very short period. When money is borrowed or lent for a day, it is known as Call (Overnight) Money. Intervening holidays and/or Sunday are excluded for this purpose. Thus money, borrowed on a day and repaid on the next working day, (irrespective of the number of intervening holidays) is "Call Money". When money is borrowed or lent for more than a day and

up to 14 days, it is "Notice Money". No collateral security is required to cover these transactions.

2. ***Treasury Bills:*** Treasury Bills are short term (up to one year) borrowing instruments of the union government. It is an IOU of the Government. It is a promise by the Government to pay a stated sum after expiry of the stated period from the date of issue (14/91/182/364 days i.e. less than one year). They are issued at a discount to the face value, and on maturity the face value is paid to the holder. The rate of discount and the corresponding issue price are determined at each auction.

3. ***Certificates of Deposits (CDs):*** Certificates of Deposit is a negotiable money market instrument and issued in dematerialized form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. CDs can be issued by:

   (a) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and

   (b) select All India Financial Institutions that have been permitted by RBI to raise short- term resources within the umbrella limit fixed by RBI.

   Banks have the freedom to issue CDs depending on their requirements. An FI may issue CDs within the overall umbrella limit fixed by RBI, i.e., issue of CD together with other instruments viz., term money, term deposits, commercial papers and intercorporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

4. ***Commercial Papers (CPs):*** CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt obligation is transformed into an instrument. CP is thus an unsecured promissory note privately placed with investors at a discount rate to face value determined by market forces. CP is freely negotiable by endorsement and delivery. Guidelines for issue of CP were for long governed by various directives issued by the Reserve Bank of India, as amended from time to time. On incorporating all the existing guidelines/instructions/directives on the subject was issued by the office of Chief General Manager of RBI, which states the following:

(a) *Who can Issue Commercial Paper:* Corporates, Primary Dealers (PDs) and the All India Financial Institutions (FIs) that have been permitted to raise short-term resources under the umbrella limit fixed by the Reserve Bank of India are eligible to issue CP.

A corporate would be eligible to issue CP provided: (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than 4 crores;

(b) company has been sanctioned working capital limit by bank/s or all-India financial institution/s; and (c) the borrowal account of the company is classified as a Standard Asset by the financing bank/s/institution/s.of Commercial Paper from either the Credit Rating Information Services of India Ltd. (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the FITCH Ratings India Pvt. Ltd. or such other credit rating agencies as may be specified by the Reserve Bank of India from time to time, for the purpose. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies. The issuers shall ensure at the time of issuance of CP that the rating so obtained is current and has not fallen due for review.

Maturity: CP can be issued for maturities between a minimum of 7 days and a maximum up to one year from the date of issue. The maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid.

(a) *Denominations:* CP can be issued in denominations of ₹ 5 lakhs or multiples thereof. Amount invested by a single investor should not be less than 5 lakhs (face value).

(b) *Limits and the Amount of Issue of CP:* CP can be issued as a "stand alone" product. The aggregate amount of CP from an issuer shall be within the limit as approved by its Board of Directors or the quantum indicated by the Credit Rating Agency for the specified rating, whichever is lower. Banks and FIs will, however, have the flexibility to fix working capital limits duly taking into account the resource pattern of companies' financing including CPs.

(c) An FI can issue CP within the overall umbrella limit fixed by the RBI, i.e., issue of CP together with other instruments, viz., term money borrowings, term deposits, certificates of deposit and inter-corporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

The total amount of CP proposed to be issued should be raised within a period of two weeks from the date on which the issuer opens the issue for subscription. CP may be issued on a single date or in parts on different dates provided that in the lattercase, each CP shall have the same maturity date.

Every issue of CP, including renewal, should be treated as a fresh issue.

(d) *Who can Act as Issuing and Paying Agent (IPA):* Only a scheduled bank can act as an IPA for issuance of CP.

(e) *Investment in CP:* CP may be issued to and held by individuals, banking companies, other corporate bodies registered or incorporated in India and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs). However, investment by FIIs would be within the limits set for their investments by Securities and Exchange Board of India (SEBI).

(f) *Mode of Issuance:* CP can be issued either in the form of a promissory note (Schedule I) or in a dematerialised form through any of the depositories approved by and registered with SEBI.

CP will be issued at a discount to face value as may be determined by the issuer. No issuer shall have the issue of CP underwritten or co-accepted.

(g) *Procedure for Issuance:* Every issuer must appoint an IPA for issuance of CP. The issuer should disclose to the potential investors its financial position as per the standard market practice. After the exchange of deal confirmation between the investor and the issuer, issuing company shall issue physical certificates to the investor or arrange for crediting the CP to the investor's account with a depository.