

UNIT 2: FINANCIAL MARKETS

SYLLABUS

Capital markets, Money Markets, Foreign Exchange Market, Commodity, Markets, Derivative Markets
Meaning, classification and structure ,sub-segments, Role played, participants.

Introduction

A financial market is a word that describes a marketplace where bonds, equity, securities, currencies are traded. Financial market is the place where financial transaction take place. A Financial Market is referred to space, where selling and buying of financial assets and securities take place. It serves as an agent between the investors and savers by mobilizing capital between them

Financial markets are the environments where buyers and sellers interact with one another to purchase, trade and sell assets like bonds and shares. These markets include trading houses, such as the New York Stock Exchange and NASDAQ. It is through financial markets and institutions that the financial system of an economic works. Financial markets refer to the institutional arrangements for dealing in financial assets and credit instruments of different types such as currency, cheques, bank deposits, bills, bonds etc.

FUNCTIONS FINANCIAL MARKET

1. Helps in Capital formation.

The financial market plays an important role in mobilisation of savings and channels them into productive investments for the development of commerce and industry. As such, the financial market helps in financial formation and economic growth of the country.

2. Act as link between savers and investors.

The financial market acts as an important link between savers and investors. The savers are lenders of funds while investors are borrowers of funds. The savers who do not spend all their income are called "Surplus units" and the borrowers are known as "deficit units. The financial market is the transmission mechanism between surplus units and deficit units. It is a conduit through which surplus unity lend their surplus funds to deficit units.

3. Helps in increasing national income.

Funds come into the financial market from individuals and financial intermediaries and are used by commerce, industry and government. It thus facilitates the transfer of funds to be used more productively and profitability to increases the national income.

4. Facilitates buying and selling.

Surplus units buy securities with their surplus funds and deficit wits ellsecurities to raise the funds they need. Funds flow from lenders to borrowers either directly or indirectly through financial institutions such as banks, unit trusts, mutual funds, etc. The borrowers issue primary securities which are purchased by lenders either directly or indirectly through financial institutions.

5. Channelizes funds from unproductive to productive resources.

The financial market provides a market mechanism for those who have savings and to those who need funds for productive investments. It divers resources from wasteful and unproductive channels such as gold, jewellery, real estate, conspicuous consumption, etc, to productive investments

6. Minimises speculative activities.

It does so by providing financial to the needy at reasonable interest rates and helps in minimizing speculative activities.

7. Brings stability in value of stocks.

A well - developed financial market comprising expert banking and non - banking intermediaries brings stability in the value of stocks and securities..

8. Promotes economic growth. The financial market encourages economic growth. The various institutions which operate in the financial market give quantities and qualitative direction to the flow of funds and bring rational allocation of resources. They do so by converting financial assets into productive physical assets. This leads to the development of commerce and industry through the private and public sector, thereby inducing economic growth.

TYPES OF FINANCIAL MARKETS

The financial market may or may not have a physical location, i.e. the exchange of asset between the parties can also take place over the internet or phone also.

1. **Stock Market:** It is a place where shares of public listed companies are traded. A stock exchange facilitates stock brokers to trade company stocks and other securities. It provides financing through the issue of shares. A stock may be bought or sold only if it is listed on an exchange.
2. **Bond Market:** The bond market often called the debt market, fixed-income market, The bond market broadly describes a marketplace where investors buy debt securities that are brought to the market by either governmental entities or publicly-traded corporations.
3. **Commodity Market:** A commodity market is a physical or virtual marketplace for buying, selling, and trading raw or primary products. Commodities are split into two types: hard and soft commodities. Hard commodities are typically 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.
4. **Money Market:** Money market basically refers to a section of the capital market where capital instruments with high liquidity and short-term maturities are traded. Money market has become a component of the capital market for buying and selling of securities of short-term maturities, of one year or less, such as treasury bills and commercial papers.
5. **Derivatives market:** The derivatives market is the capital market for derivatives, capital instruments like futures contracts or options, which are derived from other forms of assets. It provides instruments for the management of capital risk.

Example: If Mr. A want to buy a flat which is in work in progress, he can book a flat by paying 60,00,000 Rupees and entered into future contract with flat seller that he will pay only 60,00, 000

even if price of flats will increase in 2021 to 70,00,000 rupees. So here by making derivative contract with flat seller, Mr. A try to save his 10,00,000 rupees in year 2021. so with the help of derivative contract Mr. A cover his future Risk.

6. **Future Markets:** A futures market is an auction market in which participants buy and sell commodity and futures contracts for delivery on a specified future date. Futures are exchange-traded derivatives contracts that lock in future delivery of a commodity or security at a price set today.

Example: Mr. A , Mr. B and Mr. C want to buy same flat costing 60,00,000 Rupees. So there will auction or competition takes place among three to buy same flat. Mr. A ready to Pay – 65,00,000 , Mr. B ready to pay – 70,00,000 and Mr. C ready to Pay 75,00,000 for that flat. Which price will increase to 80,00,000 in 2021. Mr. C will be successful in buying flat and can enter into future contract with flat Seller. So he will try to reduce the risk of paying 5,00,000 rupees in 2021.

7. **Insurance Markets:** According to the Capital Times Lexicon, the insurance market is simply the "buying and selling of insurance." Consumers or groups buy insurance for risk management from insurers offering coverage for specific risks.
8. **Foreign Exchange Market:** The foreign exchange market (Forex, FX, or currency market) is a global decentralized or over-the-counter (OTC) market for the trading of currencies. This market determines foreign exchange rates for every currency. It includes all aspects of buying, selling and exchanging currencies at current or determined prices.

Example: In the market for Euros, the Euro is being bought and sold, and is being paid for using another currency, such as the yen.

9. **Capital Market:** Capital market is a market where buyers and sellers engage in trade of capital securities like bonds, stocks, etc. The buying/selling is undertaken by participants such as individuals and institutions. his market trades mostly in long-term securities.
 - a. **Primary Market:** The primary market is where securities are created. It's in this market that firms sell (float) new stocks and bonds to the public for the first time. An initial public offering, or IPO, is an example of a primary market.
 - b. **Secondary Market:** This is the market wherein the trading of securities is done. Secondary market consists of both equity as well as debt markets. Securities issued by a company for the first time are offered to the public in the primary market. Once the IPO is done and the stock is listed, they are traded in the secondary market

CAPITAL MARKET

Capital market is a market for financial assets which have a long or indefinite maturity. Unlike money market instruments the capital market instruments become mature for the period above one year. The capital market is a market for capital assets which have a long or indefinite

maturity. Generally, it deals with long term securities which have a maturity period of above one year

ROLE OF CAPITAL MARKET

- **Mobilization of Savings** : Capital market is an important source for mobilizing idle savings from the economy. It mobilizes funds from people for further investments in the productive channels of an economy.
- **Capital Formation** : Capital market helps in capital formation. Capital formation is net addition to the existing stock of capital in the economy.
- **Provision of Investment Avenue** : Capital market raises resources for longer periods of time. Thus it provides an investment avenue for people who wish to invest resources for a long period of time.
- **Speed up Economic Growth and Development** : Capital market enhances production and productivity in the national economy by generation of employment and development of infrastructure.
- **Service Provision** : As an important financial set up capital market provides various types of services. It includes long term and medium term loans to industry, underwriting services, consultancy services, export finance, etc. These services help the manufacturing sector in a large

CAPITAL MARKET STRUCTURE

Capital market may be further divided into three namely:

1. Industrial securities market
2. Government securities market
3. Long term loans market

1. INDUSTRIAL SECURITIES MARKET:

It can be further subdivided into two. They are:

(i) PRIMARY MARKET OR NEW ISSUE MARKET

Primary market is a market for new issues or new capital claims. Hence, it is also called New Issue market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new capital securities for long term funds. Thus,

primary market facilitates capital formation. There are three ways by which a company may raise capital in a primary market. They are: (i) Public issue (ii) Rights issue (iii) Private placement

The most common method of raising capital by new companies is through sale of securities to the public. It is called **public issue**. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called **rights issue**. **Private placement** is a way of selling securities privately to a small group of investors.

(ii) SECONDARY MARKET OR STOCK EXCHANGE

Secondary market is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted the Stock Exchange and it provides a continuous and regular market to buying and selling of securities. This market consists of all stock exchanges recognised by the Government of India. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act 1956.

II. GOVERNMENT SECURITIES MARKET

It is otherwise called Gilt - Edged securities market. It is a market where Government securities are traded. In India there are many kinds of Government Securities - short term and long term. Long term securities are traded in this market while short term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi Government authorities like City Corporations, Port Trusts etc Improvement Trusts, State Electricity Boards, All India and State level SScapital institutions and public sector enterprises are dealt in this market.

III. LONG TERM LOANS MARKET

Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers. Long term loans market may further be classified into:

1. Term Loans Market

In India, many industrial financing institutions have been created by the Government both at the national and regional levels to supply long term and medium term loans to corporate customers directly as well as indirectly. These development banks dominate the industrial finance in India. Institutions like IDBI, IFCI, ICICI, and other capital corporations come under this category.

2. Mortgages Market

A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage.

KEY PARTICIPANTS OF THE CAPITAL MARKET

- **SEBI (Regulator):** SEBI stands for Securities & Exchange Board of India. SEBI is the regulatory authority of the Capital and Securities Market.
- The main objective of SEBI is to protect the interests of investors in securities. also, to promote the development and regulate the securities market.

- **Stock Exchange:** Stock Exchanges is a Place where the Securities are Traded. Securities include Shares, Debentures, Bonds, Government Securities, and Mutual Funds Units.
- There are **two Leading Stock Exchange** in India.
- **Bombay Stock Exchange Limited (BSE)**
- **National Stock Exchange (NSE)**
- **Clearing Corporation or Clearing House:** Clearinghouse is an exchange-associated body charged with the function of ensuring (guaranteeing) the financial integrity of each trade. Orders are cleared by means of the clearinghouse acting as the buyer to all sellers and the seller to all buyers.
- **Depositories and Depository Participants:** Depository Services is an organization where the securities of a shareholder are held in the form of electronic accounts, in the same way as a bank holds money. The depository also provides services related to various transactions in such securities.
- In India, there are two depositories namely National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL).
- **Custodians/Clearing Members:** Clearinghouse takes trading information from the exchange and passes the trade details to custodians/clearing members. Custodians confirm the obligations of the parties by netting.
- **Stock-Brokers and their Sub-Brokers:** Stock Broker is the person who acts on behalf of a Trading Member and helps in dealing with securities such as Shares, Bonds, Debenture, and so on. Sub-Broker is the intermediately between the Stock Broker and Client.
- **Merchant Bankers:** The person who entered into the business of issue management and dealt with buying, selling of the Securities. also, give Consultancy services to the member
- **Credit Rating Agencies:** Agencies that allot the Credit Rating based on the ability to make payment and their Credit score. CRISIL is the best Credit Rating Agencies that give Credit Rating. it wholly depends on the financial Creditability of the person.
- **Financial Institutions:** Financial Institutions is engaged in the Financial transaction Business such as deposit of cash, Loan and Investment. it can act as Bank, Brokerage Firm, and Insurance Company.
- **Foreign Institutional Investors:** Foreign Institutional Investors is Investor, who invests outside the Country. it includes the Insurance Company, Investment Company, Mutual Fund, and Hedge Funds.
- **Non-Banking Institutions:** it is the Institution but they don't have a full license of Banking. Non-Banking Institutions mainly engage in the business loan and Advances, Purchase of share and bonds issued by the government.
- **Issuer/Registrar and Transfer Agents:** Issuer is the organization having the purpose of generating funds by selling securities.
- **Investors:** Investors are the lifeline of any capital market. A vibrant capital market should be capable enough to attract the savings of investors. Investors belong to

various categories such as Retail Investors, Institutional Investors like mutual funds, insurance companies, and Foreign Portfolio Investors.

- **Intermediaries:** Intermediaries are those entities that offer various services in relation to the capital markets. There are various categories of intermediaries such as stockbrokers, merchant bankers, underwriters, etc.

MONEY MARKET:

It is the marketplace where the short term securities.(Maturity is less than a year), like treasury bills, Repo, commercial papers etc are issued and traded (sold & purchased) over the counter among people. Money market basically refers to a section of the capital market where capital instruments with high liquidity and short-term maturities are traded. Money market has become a component of the capital market for buying and selling of securities of short-term maturities, of one year or less, such as treasury bills and commercial papers.

Definition:

According to Crowther ,

“ Money Market a collective name given to the various firms and institutions that deal in the various grades of near money”. all the forms of different kinds of money as they can be negotiated at any moment if one desires to convert these into hard cash.

As per RBI definitions “ A market for short terms capital assets that are close substitute for money, facilitates the exchange of money in primary and secondary market”

TYPES OF MONEY MARKET INSTRUMENTS

1. Treasury Bills:

Treasury bills or T- Bills are issued by the Reserve Bank of India on behalf of the Central Government for raising money. It is first issued by Indian Government in 1917. It is a short term capital instruments. T- Bills are issued with 3 different maturity periods, 91 days/ 3 months T-Bills, 182 days/6 months T- Bills, 1 year/ 364 days T – Bills.

T-Bills are issued at a discount to the face value. At maturity, the investor gets the face value amount. The difference between the initial value and face value is the return earned by the investor. They are the safest short term fixed income investments as they are backed by the Government of India.

Example: Treasury bill which has face value 20,000 rupees but it is issued by Government at discount value to 18,000 rupees to Mr. A so Mr. A will pay 18,000 rupees to the government and

buy the treasury bill for 182 days/ 6 months. But after maturity period Government can repay the same at face value 20,000 so Mr. A return is 2,000 rupees.

2. **Commercial papers:**

It is known as Promissory Notes. Large companies and businesses issue Commercial Papers (CPs) to raise capital to meet short term business needs Corporates, primary dealers (PDs) and All-India Capital Institutions (FIs) can issue CPs. It is issued at discount rate from their Face value. CPs have a fixed maturity period a minimum of 7 days and a maximum of up to 1 year from the date of issue

Investors can trade this instrument in the secondary market. They offer relatively higher returns compared to that from treasury bills.

3. **Certificate of Deposits (CD):**

CD is the Borrowing Note for short term just similar to promissory note. CDs are capital assets that are issued by banks and capital institutions. They offer fixed interest rate on the invested amount. The maturity period of Certificates of Deposits ranges from 7 days to 1 year, if issued by banks. And for capital institutions can issue a CD with maturity ranging from 1 year to 3 years. The bearer of a Certificate of deposit receives interest.

4. **Banker's Acceptance (BA):**

Banker's Acceptance or BA is basically a document promising future payment which is guaranteed by a commercial bank. Similar to a treasury bill, Banker's Acceptance is often used in money market funds and specifies the details of the repayment like the amount to be repaid, date of repayment and the details of the individual to which the repayment is due. Banker's Acceptance features maturity periods ranging between 30 days up to 180 days.

5. **Bills Discounting/ Bills of Exchange:**

A bill of exchange transaction can involve up to three parties. The drawee is the party that pays the sum specified by the bill of exchange. The drawer is the one who receives that sum. The drawer is the party that obliges the drawee to pay the payee. The drawer and the payee are the same entity unless the drawer transfers the bill of exchange to a third-party payee. (Banks) It can be issued for period of 3 Months

Example: Let's say Company ABC purchases auto parts from Car Supply XYZ for 25,000 Rupees. Car Supply XYZ draws a bill of exchange, becoming the drawer and payee in this case. The bill of exchange stipulates that Company ABC will pay Car Supply XYZ 25,000 Rupees in 90 days/ 3 Months.

6. **Money Market Mutual Fund:**

A money market mutual fund is an open-ended scheme, which invests money in high-quality liquid instruments like treasury bills, commercial paper, certificates of deposits and repurchase agreements, with having less than one-year of maturity time period.

These mutual funds especially, the liquid fund invests your money in very short-term market instruments with maturity up to 91 days where you can actually keep your money for very short periods of 1-3 months and this can serve as an emergency fund.

The money invested in money market mutual funds can be used for emergency hospitalization, child's school fees, vacation planned over the next 2 to 3 months.

7. **Repurchase Agreements (Repo)**

Repo's are also known as Reverse Repo or as Repo. They are loans of short duration which are agreed by buyers and sellers for the purpose of selling and repurchasing. these transactions can be carried out between RBI approved parties

9. **Call and Notice Money:**

Call and Notice Money exist in the market. With respect to Call Money, the funds are borrowed and lent for one day, whereas in the Notice Market, they are borrowed and lent up to 14 days, without any collateral security.

The commercial banks and cooperative banks borrow and lend funds in this market. However, the all-India capital institutions and mutual funds only participate as lenders of funds.

STRUCTURE OF THE INDIAN MONEY MARKET

The Indian Money Market can be categorised into two sectors; viz., **Organised** or **Modern Sector**, and **Unorganised** or **Indigenous Sector**.

Main components of Unorganised Money Market:

Indigenous Bankers (IBs): The IBs are individuals or private firms who **receive deposits** and **give loans** and thereby they operate as banks. Unlike moneylenders who only lend money, IBs accept deposits as well as lend money.

Money Lenders (MLs): They lend money in rural areas as well as urban areas. They normally charge an invariably high rate of interest ranging between **15% p.a. to 50% p.a.** and even more.

Chit Funds and Nidhis: They collect funds from the members for the purpose of lending to members (who are in need of funds) for personal or other purposes.

PARTICIPANTS IN THE MONEY MARKET

- **Central Government:** The Central Government is an issuer of Government of India Securities (G-Secs) and Treasury Bills (T-bills). These instruments are issued to finance the government as well as for managing the Government's cash flow. G-Secs are dated (dated securities are those

which have specific maturity and coupon payment dates embedded into the terms of issue) debt obligations of the Central Government

- **State Government:** The State Governments issue securities termed as State Development Loans (SDLs), which are medium to long-term maturity bonds floated to enable State Governments to fund their budget deficits
- **Scheduled Commercial Banks (SCBs):** Banks issue Certificate of Deposit (CDs) which are unsecured, negotiable instruments. These are usually issued at a discount to face value. They are issued in periods when bank deposits volumes are low and banks perceive that they can get funds at low interest rates. Their period of issue ranges from 7 days to 1 year.
- **Private Sector Companies:** Private Sector Companies issue commercial papers (CPs) and corporate debentures. CPs are short-term, negotiable, discounted debt instruments. They are issued in the form of unsecured promissory notes. They are issued when corporations want to raise their short-term capital directly from the market instead of borrowing from banks
- **Primary Dealers (PDs)** The organization of Primary Dealers was conceived and permitted by the Reserve Bank of India (RBI) in 1995. These are institutional entities registered with the RBI

FOREIGN EXCHANGE MARKET

- Foreign Exchange Trading is a contract between two parties. There are three types of trades. The spot market is for the currency price at the time of the trade. The forward market is an agreement to exchange currencies at an agreed-upon price on a future date.
- A swap trade involves both. Dealers buy a currency at today's price on the spot market and sell the same amount in the forward market. This way, they have just limited their risk in the future. No matter how much the currency falls, they will not lose more than the forward price.

Participants in the Foreign Exchange Market

- **Central Bank:** The central bank regulates the exchange rates of the currency of their respective country to ensure fluctuations within the desired limit and keep control over the money supply in the market.
- **Commercial Banks:** The commercial banks are the medium of forex transactions, facilitating international trade and exchange to its customers along with other forex functions like making foreign investments.
- **Traditional Users:** The traditional users involve foreign tourists, companies carrying out [business](#) operations across the globe, patients taking treatment in other country's hospitals and students studying abroad.
- **Traders and Speculators:** The traders and speculators are the opportunity seekers and look forward to making a profit through trading on short-term market trends.
- **Brokers:** They are considered to be financial experts who act as an intermediary between the dealers and the investors by providing the best quotations.

ADVANTAGES OF FOREIGN EXCHANGE MARKET

- **High Leverage:** A forex investor can avail the facility of leverage or loan of up to 20 or 30 times of his/her capacity, for trading in the forex market.
- **International Trade:** Every country has its currency and therefore, to facilitate trade activities between two countries, the forex market is essential.
- **Trading Option:** For the speculators or traders, foreign exchange market is just like other financial markets where they can make money on short term fluctuations in the currencies.
- **Flexibility:** We know that the forex market is a twenty-four-seven market, and there is no minimum or maximum limit of the exchange amount. It provides the flexibility of [investment](#) or exchange to the traders.
- **Hedging Risk:** The forex market provides for hedging the risk of loss on currency fluctuations while carrying global business operations and trading in foreign currency.
- **Low Transaction Costs:** Since brokers are not very much entertained in the forex market, the transaction cost (called as 'spread') charged by the dealers is reasonably low if compared to other financial markets.
- **Inflation Control:** To maintain the economic stability in the country and control situations like inflation, the central bank maintains a forex reserve which consists of currencies of different countries around the world.

COMMODITY MARKET

A commodity is a group of goods or assets that are used in our day to day lives such as metals, agriculture, energy, etc.

Commodity Market implies the place where products, either produced or grown are being traded between investors. It brings together all the participants to determine the price, at which the commodity can be traded across the market.

Classification of Commodities

- **Hard Commodities:** It entails natural resources which require mining and extracting, for example, gold, oil, silver, copper, zinc, etc.
- **Soft Commodities:** It entails agricultural produce and livestock, for example, wheat, cotton, pulses, coffee, sugar, soybean, etc
- More recently developed commodities markets include those for emissions, electricity, and cell phone minutes

COMMODITY STOCK EXCHANGES IN INDIA

- Indian Commodity Exchange – ICEX
- Ace Derivatives Exchange – ACE
- National Multi Commodity Exchange – NMCE

- The Universal Commodity Exchange – UCX
- Multi Commodity Exchange – MCX
- National Commodity and Derivatives Exchange – NCDEX
- From the above **MCX and NCDEX** are the most popular exchanges
- Commodity Market is regulated by the **Securities and Exchange Board of India (SEBI)**.

ROLE OF COMMODITIES MARKET IN INDIA

1. **Food Security:** The commodities market in India play a crucial role in ensuring that the suppliers of commodities are protected against falling prices. They can utilise the commodities futures contracts to lock in a price that they think is apt for their products. It ensures that there will be an adequate supply of commodities throughout the country.
2. **Better agriculture infrastructure:** Within the commodities market, farmers suffer at the hands of inadequate post-harvest infrastructure. Even though they produce a high quantity of commodities, the lack of adequate warehousing, transport etc., forces them to suffer losses. Commodities market offers profits to farmers, brokers, intermediaries and customers. Thus, attracting investments in the agriculture sector in the hope of better long term profits.
3. **An organised platform:** Before the commodities market, the farmers or the suppliers of commodities only relied on middlemen to sell their products. It forced them to take whatever amount the middlemen offered. However, today, the commodity market ensures that they can utilise an organised platform to trade their commodities and realise an adequate price.
4. **A new asset class:** The role of the commodities market is not limited to farmers or suppliers but extends to offer a new asset class for investors seeking profits. By trading in commodities, they can hedge against losses from other asset classes, diversify their portfolio, while helping in the overall growth of the commodity sector in India.
5. **Mitigates Volatility:** This is one of the most important roles of the commodity market in India. It helps protect the originator of the risk and results in the overall distribution of the risk exposure. For example, a jeweller can sell a gold futures contract to avoid any rise in the gold prices in the upcoming months. However, the same futures contract can be bought by an investor with the intention that the gold prices will rise in the future. Through the contract, the risk gets distributed and mitigates a high level of volatility.

DERIVATIVES

Introduction to Derivatives

Meaning: Derivative is a product whose value is derived from the value of one or more underlying asset.

The underlying asset can be equity forex, commodity or any other asset.

Definition :- Derivatives

In the Indian context the securities contracts (Regulation) Act,1956 defines “derivative” to include “A contract which derives its value from the prices, or index of prices, of underlying securities”.

TYPES OF DERIVATIVES

- 1. Forward contract**
- 2. Future contract**
- 3. Option contract**

FORWARDS CONTRACT

A Forward contract is a customized contract between two entities where settlement takes place on a specific date in the future at today’s pre-agreed price.

❖ Features of forwards contracts

- 1. Bilateral Contract:** - Contract is on agreement between two parties. Buyer and Seller both play important role in forward contract.
- 2. Counter Party Risk :-** At this contract involves two parties thus there is exposure of counter party risk wherein one party can defraud the other.
- 3. Unique :-** Forward contracts are customized in nature made in accordance with consent from both the parties. Consent (permission) could be obtained in relation to a predetermined price, maturity date, underlying asset, payment mode, etc.
- 4. Compulsory settlement :-** On the date of the expiry a forward contract has to be settled that means buyer has to take possession of underlying asset. Even though if both the parties wishes to extend the contract they can do so only by settling previous contract and then starting with a new one.
- 5. Standardized :-** Forwards contracts are not standardized they differ from parties to parties.
- 6. Trading :-** Forward contracts are traded in OTC (Over The Counter) market. There is no specific exchange where forwards are listed as contracts are not standardized in nature.

❖ Limitations Of Forwards Contracts

- 1. Counter Pay Risk :-** Derivative Product means a product which help to hedge all type of risk but then too forward being a derivative product is exposed to counter party risk just because it is not standardised one.

2. Lack of centralization of Trading :- As forward contracts are traded in OTC market there is lack of centralization. There is no proper central authority who can help in frauds happen in contracts.

3. Lack Of Transparency :- Due to trading being taken place in OTC market there is lack of transparency in these types of contracts.

4. Illiquidity :- Forwards are bilateral contracts which are not listed in any exchange and are exposed to counter party risk. If either of the one party fails to execute the contract it led to illiquidity.

FUTURE CONTRACT

Meaning

A future contract is an agreement between two parties to buy or sell an asset at a certain time in the future at certain price.

Future Contracts are standardized and Exchange traded. To facilitate liquidity in the future contracts, the exchange specifies certain standard features of the contracts.

1. **Transparency :-** Future Contracts are transparency as they are standardized and listed on exchange.

2. **Standardized:** It is a standardized contract with standard underlying instrument a standard quantity and quality of the instrument.

3. **Integrated Price :-** As future contracts are listed on exchange, stability and transparency in price is being maintained.

4. **Exchange Traded :** Future contracts are listed on Exchange & Traded like other investment products.

5. **Settlement :-** Future Contracts are settled before the Maturity date on “ Market to Market” basis. In Market to Market prices of contract are marked with market price on daily basis .

OPTION CONTRACT

Option Contract is an agreement between two parties to buy and sell an asset (a stock) at fixed price and at a fixed date in the future.

It is called as option because the buyer has the right but not the obligation (compulsion) to carry out the transaction. If, over the life of the contract, the asset value decreases, the buyer can simply decide not to exercise his or her right to buy or sell the asset.

1. Call options

Calls give the buyer the right, but not the obligation, to buy the underlying asset at the strike price specified in the option contract. Investors buy calls when they believe the price of the underlying asset will increase and sell calls if they believe it will decrease.

2. Put options

Puts give the buyer the right, but not the obligation, to sell the underlying asset at the strike price specified in the contract. The writer (seller) of the put option is obligated to buy the asset if the put buyer exercises their option. Investors buy puts when they believe the price of the underlying asset will decrease and sell puts if they believe it will increase.