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FINANCIAL INSTRUMENTS IN INDIA

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Abstract

In India, there are many families who save money on monthly basis from their income to make their future more secure. Money kept aside to meet the future need is called savings. Investments of savings help them to meet their long term needs and larger financial goals. The main reason why people refrain from investing is that there is some amount of risk attached to it. The higher the risk, the higher is the return on investment and investing smartly can multiply their savings. For investments there are many financial instruments that are available in India where the investor can invest to get the best returns. Choosing the right type of instrument is very essential. The Indian financial market consists of mainly three pillars i.e. equity, debt and derivatives. Every category has its own importance in the development of financial market. A financial instrument is a document or contract that can be traded in a market, which represents an asset to one party and a liability to the other. The purpose of the study is to know about various financial instruments which are available for investments in India. This paper provides a brief description of all of these.

Keywords: - *Financial, Instruments, Investments, Savings.*

Introduction: - Financial Instruments are monetary contracts between parties. They can be created, traded, modified and settled. They can be in cash, evidence of an ownership interest in an entity or a contractual right to receive or deliver cash. Financial instruments include primary financial instruments like receivables, payables, loans and advances, debentures and bonds, investments in equity instruments, cash and bank balances, derivative instruments like options, futures, forwards, swaps, cap, collar, floor, forward rate agreement etc. A derivative with a positive value is financial assets and with negative value is financial liability. A capital market is a place where both government and companies raise long term funds to trade securities on the bond and the stock market. It consists of both the primary market where new securities are issued among investors and the secondary market where already existed securities are traded. In the capital market, commodities, bonds and equities and other such investment funds are traded.

There are 22 stock exchanges in India, first being the Bombay Stock Exchange (BSE), which began formal trading in 1875. Over the past few years, there has been a swift change in the Indian capital market, especially in the secondary market. In terms of the number of companies and total market capitalization in share market, the Indian equity market is considered large relative to the country's stage of economic development.

Objectives of the study: - 1) To study the various financial opportunities available for investment.

2) To study the nature of various financial instruments in India.

Research Methodology: - 1) The descriptive methodology has been used to collect data.

2) Secondary data has been collected from various published sources and website.

3) The explanation of data is qualitative than on quantitative terms.

Classification of Financial Instruments: - Financial Instruments are classified into two types namely-

1) **Cash Instruments: -** The value of the cash instruments are directly influenced and determined by the markets. These are the kind of securities which are easily transferred.
2) **Derivative Instruments: -** The value and characteristics of derivative instruments are based on the underlying components such as assets, interest rates or indices. These can be over-the-counter derivatives or exchange-traded derivatives.

Types of Financial Instruments in India:-

1) Equities: - It is one of the best options to invest in equities over an extended period as it will fetch good returns. It is also subject to market-related risk, and one needs to do thorough research before investing in equities. It is high return risky instrument. Equity shares don't have any fixed return rate and thereby, no period of maturity. Equities are a type of security that represents the ownership in a company. Equities are traded in stock markets. Alternatively, they can be purchased via the Initial Public Offering (IPO) route, i.e. directly from the company.

Benefits of Equity: - A) Share market investments, in comparison to other types of assets; have given one of the best returns during inflation. This enables investors to maintain their current lifestyles.

B) Equity while being a risky investment, offers higher returns than a saving account or a fixed deposit because the profit that may be earned is virtually unlimited.

C) It is possible to minimize risks and maximize profits through the use of equity derivatives, specifically by trading in the options market.

D) Using sound shares market knowledge to invest in equity is the key to building a large corpus for a future financial need.

E) Investing in the equity of reputable companies have the added benefit of dividends.

2) Government Securities: - In India, mainly the institutional investors buy the government securities. The government, both Central and State and the government authorities, for example State electricity boards, municipalities etc issue it. Commercial banks are the biggest investors who buy the government securities. The government collects money through the government securities to finance its several new infrastructure development projects or to meet its present needs.

Government securities are usually considered low risk investments because they are backed by the taxing power of a government. Government securities such as saving bonds, treasury bills and notes also promise periodic coupon or interest payments. The Treasury department issues government securities through auctions to institutional investors for buying and selling. Retail investors buy government securities directly from the Treasury Department's Website, banks or brokers. Since most government securities are backed by the full faith and credit of the government, default is unlikely.

Government securities are exempt from state and local taxes, making government bonds advantageous for investors in high tax brackets. The bonds are very liquid, but have low rates of return. The securities rarely protect against inflation and have little or no capital gains opportunity. With their steady income streams, government securities are a conservative choice in a fluctuating market.

3) Mutual Fund: - Mutual fund is a trust that pools the savings of number of investors who share a common financial goal through various schemes. The money thus collected is then invested in capital market instruments such as shares debentures and other securities in accordance with the schemes of objective. The incomes earned through these investments are shared by the unit holders. Thus a Mutual Fund is one of the most suitable investment instruments for the common man as it offers an opportunity to invest in diversified, professionally managed securities at a relatively low cost.

Mutual Funds in India are being distributed by various channels like: Corporate Distributors, Individual Distributors, Post Offices and Banks. All these distribution channels are broadly divided into two key types- One who sell funds with low expenses ratio but charges from the customers on their own. Another who sells funds with high expense ratio and get paid back as commission, they don't charge any fees from customers. The former one sells the MF plans labeled as 'Direct Plans' and the later one sells the MF Plans labeled as 'Regular Plans'.

Mutual Funds are controlled by an Assets Management Company (AMC) that collects funds from a group of investors and invest these funds in bonds, stocks and securities. When you purchase units of a Mutual Fund, these units denote the holdings of your share in certain fund scheme. You can purchase or even redeem a Mutual Fund at the prevailing Net Assets Value (NAV).

4) Futures and Options: - Derivatives Instruments are a Financial Contracts which solve the primary purpose of hedging the asset price fluctuation. It derives value from its underlying assets, hence it is called derivatives. There are various types of derivative used worldwide but in India currently we have Two Exchange Traded Derivatives namely Futures and Options. The fundamental difference between Options and Futures lies in the obligations they put on their buyers and sellers. An Option gives the buyer the right, but not the obligation, to buy or sell a certain asset at a specific price at any time during the life of the contract. People who buy Options are called holders and those who sell Options are called writers of Options. A Futures contract gives the buyer the obligation to purchase a specific asset, and the seller to sell and deliver that asset at a specific future date, unless the holder's position is closed prior to expiration.

In general, Futures trading is considered riskier than buying and selling stocks, primarily because of the leverage involved. Still, Futures are popular trading instruments among a variety of market participants- from small retail traders to high frequency trading firms. To become a successful Futures and Options trader, it is necessary to know the depth of it.

5) Bonds: - Bonds are issued by both private and government entities to raise their working capital. Bonds are also called as fixed income instruments. Central and State Government both issue bonds and private organizations like private companies, private financial instruments also issue bonds to increase their funds. Government bonds carry the lowest amount of risk but they take time to give the returns. As far as return on investment is concerned private bonds offers better returns but they carry high amount of risk. The most common process for issuing bonds is through underwriting. A bond is a form of loan. The holder of the bond is the lender, the issuer of the bond is the borrower and the coupon is the interest. Bonds provide the borrower with external funds to finance long term investments and in case of government bonds, to finance current expenditure.

Bonds and stocks are both securities but the major difference between the two is that stockholders have an equity stake in the company whereas bondholders have a creditor stake in the company. Another difference is that bonds usually have a defined term, or maturity, after which bond is redeemed, whereas stocks may be outstanding indefinitely.

6) Deposits: - Investing in bank or post office deposits is a very common way of securing surplus funds. It is identical to the money an investor transfers into a bank's saving or checking accounts. It can be made by individuals or entities such as corporations. The money is still owned by the person or entity that deposited the money and it can be withdrawn at any time, transferred to another person's account or used to purchase goods. Often, a person must deposit a certain amount of money in order to open a new bank account, which is known as a minimum deposit. This amount covers the cost associated with opening and maintaining the account.

The exception to this rule is a time deposit, also known as a term deposit, which is a saving account that restricts withdrawals within a certain time period. In most cases, the depositor must give notice prior to withdrawing funds before the time limit expires, and there are fees for doing so.

When money is deposited into a banking account, it earns interest. This means that, at fixed intervals, a small percentage of the account's total is added to the amount of money already in the account. Interest can be compounded at different rates and frequencies depending on the bank or institution. So it is a good idea to look around for the best interest rates before committing to a saving account. Time deposits, CDs that restricts withdrawals offer a high interest rate, which allows you to save more money, more quickly.

7) Preference Shares: - Preference shares are known as preferred stock. Preference share capital has two priorities i.e. in the repayment of capital and payment of dividend. Preferred stocks usually carry no voting rights. Therefore, a company can raise capital without dilution of control. Most preference shares have a fixed dividend, while common stocks generally do not. Preference shares fall under four categories: cumulative preferred stock, non-cumulative preferred stock, participating preferred stock and convertible preferred stock. Preference shares are an optimal alternative for risk-averse equity investors. Preference shares are typically less volatile than common shares and offer investors a steadier flow of dividends.

Also preference shares are usually callable; the issuer of shares can redeem them at any time, providing investors with more options than common shares.

The rate of dividend on preference shares is fixed. Therefore, with the rise in its earnings, the company can provide the benefits of trading on equity to the equity shareholders. Preference shares do not create any mortgage or charge on the assets of the company. The company can keep its fixed assets free for raising loans in future. A company can issue redeemable preference shares for a fixed period. The capital can be repaid when it is no longer required in business. There is no danger of over capitalization and the capital structure remains elastic. Preference shares can be made more popular by giving special rights and privileges such as voting rights, right of conversion into equity shares, right of shares in profits and redemption at a premium.

8) Debentures: - A debenture is a medium to long term debt format that is used by large companies to borrow money. A debenture is a type of debt instrument that is not secured by physical assets or collateral. Debentures are backed only by the general creditworthiness and reputation of the issuer. Bond buyers generally purchase debentures based on the belief that the bond issuer is unlikely to default on the repayment. Debentures are the most common form of long term loans that can be taken out by a corporation. These loans are repayable on a fixed date and pay a fixed rate of interest. A company normally makes these interest payments prior to paying out dividends to its shareholders.

Issue of debentures does not result in dilution of interest of equity shareholders as they do not have right either to vote or take part in the management of company. Interest on debentures is tax deductible and thus it saves income tax. Cost of debenture is relatively lower than preference shares and equity shares. Issue of debenture is also advantageous during times of inflation. Interest on debenture is payable even if there is a loss, so debenture holders bear no risk.

9) Hybrid Instruments: - Hybrid instruments have both the feature of equity and debenture. A hybrid security is a single financial security that combines two or more different financial instruments. The most common type of hybrid security is a convertible bond that has features of an ordinary bond but is heavily influenced by the price movements of the stock into which it is convertible. Hybrid securities are bought and sold on an exchange or through a brokerage. Hybrids may give investors a fixed or floating rate of returns and may pay returns as interest or as dividends. Some hybrids return their face value to the holder when they mature and some have tax advantages. Each type of hybrid security has unique risk and reward characteristics

The major advantage of this type of security is that if the corporation's stock price goes down, the option will not be exercised and you will still receive interest payments on your bonds. However, if the stock goes up, you can convert the bonds to stock at a given strike price.

10) Cash and Cash equivalents: - All the securities that can be readily converted to cash within 3 months can be called as cash and cash equivalents. In case of immediate requirement the balance helps a lot, so it is good to create corpus in saving account which can be used only in case of financial emergency. These are relatively safe and highly liquid investment options. Treasury bills, gold, money market funds are cash equivalents. Cash is money in the form of currency. This includes all bills, coins and currency notes. Cash equivalents are investments that can readily be converted into cash and that it be so near its maturity date that there is an insignificant risk of changes in value due to changes in interest rates by the time the maturity date arrives.

One of the company's crucial health indicators is its ability to generate cash and cash equivalents. If there is any question about whether a financial instrument can be classified as a cash equivalent, consult with the company auditors. Cash and cash equivalents information is sometimes used by analysts in comparison to a company's current liabilities to estimate its ability to pay its bill in the short term. However such an analysis may be flawed if there are receivables that can be converted into cash within a few days.

Best Financial Instruments in India: - The term best is subjective depending on how much risk you are willing to take. If you are someone with an appetite for risk and are willing to bear losses, the stock market will be your best option and stock market related investments like Shares, Mutual Funds will be the best instruments for you.

If you are someone who prefers safety of capital as the primary goal, then government deposit schemes like PPF or NSC or Bank Fixed Deposits may be the best financial instrument for you.

It depends totally on your willingness which security you choose for investment of your savings.

Conclusion: - In India, there are many financial instruments available. Financial instruments can be real or virtual documents representing a legal agreement involving any kind of monetary value. Financial instruments act as channels to invest the money. It acts as a tool to raise funds. Saving is a good habit but to invest your savings is even better habit. This will make you financially strong and secure in the long run and will help you to achieve your financial goals. Investing early and in a smart way can make a difference in your financial position. But for this it is very necessary that you choose a sound financial instrument and it is totally upon you that which type of instrument you will select. A financial instrument that has less risk will have a higher value than a similar instrument that has more risk. The greater the risk, the more it lowers the value of the security because risk requires compensation. An investor has to choose the best investment option to fetch the best return on the invested money.

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