

**Economic Environment and Business Strategy**  
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**Lecture- 15**

**Financial Instruments and Intermediaries**

Welcome to this session on Economic Environment and Business Strategy. In the previous lecture, we explored the structure of financial markets, how markets function to connect savers with borrowers, so in this section, we move deeper into the mechanics of that connection by focusing on two core components of the financial system: one is financial instruments and the second is the types of financial intermediaries. Moving on to the first part, types of financial instruments, we will begin by understanding the building blocks of economic transactions, namely, financial instruments. These are contracts or obligations that facilitate the transfer of money, risk, or ownership. We will examine instruments that include money markets and capital markets, such as bonds, equity (i.e., stocks), treasury bills, commercial papers, and derivatives, among others. Each instrument plays a distinct role in funding, investing, or hedging. Next, we will examine the institutions that enable financial markets to function. Intermediaries are called financial intermediaries.

These include banks, insurance companies, mutual funds, pension funds, investment firms, and government-sponsored enterprises. We will examine how they mobilize savings, allocate credit, manage risk, and maintain financial system stability. By the end of this session, you will have a clearer understanding of how these instruments and intermediaries work together to facilitate efficient financial flows and shape the broader economic and business environment. Let's get started. First, let us take a look at the key instruments traded in the money market, which is the segment of the financial market where short-term borrowing and lending occur.

Typically, maturities are less than one year. First, I'll show you a financial market instrument to give you an idea. I have provided a formal definition here. A financial instrument is the written legal obligation of one party to transfer something of value, usually money, to another party at some future date under specified conditions. You can see here in the picture that it has written "bonds, equity stocks, etc.

Could we go through it one by one? The first one is called financial instruments in the money market because in the previous session, I divided the market into two: one is called the money market, and the other is called the capital market. In the money market,

it deals with instruments that are less than one year, so let's first go through it. The money market instruments, beginning with the Treasury bills, are mainly short-term government securities with maturities of one, three, or six months. These are generally sold at a discount and redeemed at face value, which means the difference represents the interest earned.

Therefore, treasury bills are considered risk-free, as the government backs them, and commercial banks are the primary holders. Moving on to the second money market instrument, we have certificates of deposit, commonly referred to as CDs. Banks mainly issue these items. CDs are short-term time deposits with fixed interest rates. Some CDs are negotiable, meaning they can be traded in secondary markets, thus providing liquidity for the holder.

This process then proceeds to the next money market instrument, known as commercial paper, which is typically issued by large corporations. This is unsecured short-term debt issued by large corporations to meet their short-term financing needs, such as working capital. Since it's not backed by collateral, only top-rated firms with strong credit profiles can issue them at a reasonable rate. So, when I say so, there is no collateral. These are unsecured loans, which means that when they issue this commercial paper, they don't need to provide any collateral or security.

Next, we move on to another type of money market instrument: consumer loans. These are again short-term loans extended to individuals by banks or financial institutions. Due to individual credit risk, these loans typically carry higher interest rates compared to other money market instruments. Then, moving on to the next one, which is called repurchase agreements, also known as repos. Repos are very short-term loans.

So, often overnight, one party sells a security, usually a treasury bill, with an agreement to repurchase it later for a higher price. These functions are secured loans, commonly used by banks, financial institutions, and corporations. Then, moving on to the last one, this is referred to as federal funds. Federal funds, or for short, we call them fed funds. These are mainly loans between commercial banks, primarily to meet their reserve requirements at the central bank.

So, these are overnight loans between commercial banks. Typically used to meet short-term reserve requirements. The interest rate on these loans is referred to as the Fed funds rate, especially in the U.S. context. When discussing the Fed funds rate, it is primarily used in the U.S. context, particularly when many banks borrow from each other at this rate.

It's an overnight loan primarily used to meet the central bank's credit reserve requirement, serving as a key indicator of market liquidity, and often guiding monetary

policy in the US. Let's now move to the capital market. As I previously mentioned, the capital market refers to the market that deals with long-term lending, which is defined as lending that lasts more than one year. These are used for long-term financing, so I have listed every instrument commonly used in the capital markets. Let us start with one by one the stocks number one talks about, which I already mentioned.

So, stocks mean it represents an equity ownership in a company. When you purchase a stock, you essentially become a part-owner of that company. Investors can earn returns through dividends and capital gains. Stocks carry a higher risk but also a higher potential return compared to debt instruments. As I mentioned earlier, investing in stocks can yield higher returns, but it also carries a higher risk.

Similarly, the return you are getting is in the form of dividends that the company announces periodically if it is earning a profit. If the share price is increasing and the market price is high after you bought it, then if you sell, you will also receive a capital gain. Then, moving on to the second capital market instrument, mortgages: mortgages are long-term loans taken out for real estate purchases, typically repaid over 15 or 30 years. The distinguishing feature is that the property or land itself serves as collateral, reducing the lender's risk. For example, if you are buying a house, that means you will be taking out a mortgage loan; similarly, if you are purchasing a vehicle, that is also considered a mortgage loan, as the car itself serves as collateral.

That means the real estate, including the house, will serve as collateral if you take a mortgage loan for your home or vehicle. Moving on to another capital market instrument, corporate bonds are debt instruments issued by large corporations. Compared to commercial paper, certificates of deposit are also issued by a corporation, but they are typically short-term investments. However, when they issue bonds for more than one year, they are referred to as corporate bonds. These are debt instruments issued by corporations to raise capital for expansion or operation.

In the case of commercial paper, we have seen that it is primarily issued to ensure a steady cash flow, enabling the company to meet its short-term financial obligations. However, in the case of corporate bonds, they are long-term in nature and popular among institutional investors, such as insurance companies and pension funds. Individual investors also invest in these assets for stable returns. However, moving on to the next one, this is the fourth instrument, which is called government securities. These are bonds issued by a central or national government to finance budget deficits and other expenditures.

They are considered low risk and are widely held by banks, households, and foreign investors. These securities form the backbone of sovereign debt markets. Then, moving on to another type, which is municipal bonds, mainly issued by state or local

governments. Municipal bonds are used to finance public infrastructure projects, including schools, roads, and hospitals. A key feature is that they are often tax-exempt, which makes them attractive to cautious investors.

Then, the last component, the sixth form of credit market instruments, is consumer and commercial bank loans. These are consumer and commercial bank loans, which are loans given by banks to individuals for personal consumption or to businesses for investment purposes. Compared to money market loans, these are long-term; they form a significant component of the bank's capital base. In summary, capital market instruments facilitate the long-term transfer of funds from savers to users, thereby supporting productive investment and economic growth. What we have done here is make a distinction between money market instruments and capital market instruments.

Briefly, in the money market, we stated that instruments with a maturity period of less than one year are classified as money market instruments. In comparison, those with a maturity period of more than one year are classified as capital market instruments. Generally, in the money market, banks are the most dominant players. They make long-term loans and long-term investments; however, most transactions, especially those involving capital raising, are primarily conducted through deposits, which are typically held for less than one year, primarily in the money market. Let's also make a distinction between treasury bills, treasury notes, and treasury bonds, as I have already mentioned these terms repeatedly here.

Let me make a distinction here. Treasury bills are issued for terms of less than a year; treasury notes are issued for terms of 2, 3, 5, or 10 years; and treasury bonds are issued for terms of 30 years. I've created a summary table here. The instrument's maturity term is specified, the market type is identified, and its key characteristics are also listed. In the case of treasury bonds, they have the longest maturity. They also have a fixed interest payment.

Let us now move on to another component of the financial markets. So far, we have reviewed the previous sessions. We have discussed the structure of the financial market. We have just completed the discussion on types of financial instruments by distinguishing between money market instruments and capital market instruments. We will now discuss the various types of financial intermediaries.

The types of financial intermediaries include depository institutions. A depository institution is a type of financial intermediary that is the most familiar, including commercial banks, savings banks, and credit unions. They accept deposits from individuals and businesses and provide loans to borrowers. They help facilitate payments and credit creation throughout the economy.

Their role is mainly foundational. They mobilize savings and provide liquidity for economic activities. Then, another type of financial intermediary is an insurance company. Insurance firms operate by collecting premiums and investing them in financial assets such as securities or real estate. In return, they promise to compensate policyholders in the event of certain specified events, such as death, loss, or damage. Therefore, broadly speaking, insurance companies can be categorized into two types: life insurance companies, which specialize in life insurance, and non-life insurance companies, which focus on other types of insurance.

It protects against the financial risk of untimely death. Regarding general insurance, it covers risks such as property damage, theft, accidents, or personal injury; thus, life insurance is also referred to as non-life insurance, while general insurance is also referred to as life insurance. It is used interchangeably in that way, as these insurance companies manage risk for individuals and businesses while channeling premiums into productive investments. Then, we move on to another type of financial intermediary called pension funds. Pension funds collect contributions from employees and employers and invest them in long-term assets such as stocks, bonds, and real estate.

Over time, these funds grow and are used to provide retirement income. To workers, periodic payments, which are pension payments, are essential for retirement security and also act as major institutional investors in financial markets. Furthermore, another type of financial intermediary is a securities firm, which plays a more central role in capital market operations and facilitates the issuance of securities. The trading of securities, such as stocks and bonds. They primarily offer advisory services to corporate clients, particularly in mergers and acquisitions, as well as capital raising.

It includes mutual funds, which pull money from retail and institutional investors and invest in diversified portfolios. It also includes hedge funds and private equity, which cater to high-net-worth individuals and specialized investors. So, examples of securities firms include brokers, investment banks, underwriters, mutual funds, private equity firms, and venture capital firms. Now, let's proceed with the additional categories of financial intermediaries. Just for instance, here are finance companies, mainly non-banking financial intermediaries.

These institutions raise funds from financial markets, not through deposits, and use those funds. They primarily raise funds from deposits and use those funds to provide loans to individuals and businesses. Examples include loans for mortgages, automobiles, and personal use. While their assets may resemble those of banks, their liabilities are often market-traded debt instruments rather than customer deposits. Then, another type of financial intermediary is mainly government-sponsored enterprises.

Government-sponsored enterprises are publicly supported financial institutions. They serve as key developmental and social policy objectives. The government-sponsored enterprises provide direct credit and lending to priority sectors, including agriculture and housing. Examples include institutions that provide loans to farmers or assist homebuyers in accessing affordable housing financing. I have listed some examples from India, such as the National Bank for Agriculture and Rural Development (NABARD).

It provides credit and financial support for agriculture and rural infrastructure. Similarly, SIDBI, the Small Industries Development Bank of India, and HADCO, along with the NHB, help bridge financial gaps in underserved sectors, promising inclusive economic development. Together, these intermediaries enhance access to credit, promote investment, and ensure the smooth functioning of both capital and money markets. To summarize, today's discussion covered two key components of the financial system: financial instruments, which included the money market and the capital market, and financial intermediaries, which encompass institutions that connect savers with borrowers, such as banks and financial firms. Insurance firms, pension funds, security firms, finance companies, and government-sponsored enterprises.

These components help mobilize savings, allocate capital efficiently, and manage financial risks. Thank you for your careful attention to this lecture. See you in the next lecture. Thank you.