CHAPTER 2. GLOBAL FINANCIAL INSTRUMENTS

Major Classifications of Financial Assets or Securities

1. *Money Markets*

Money markets include short term, highly liquid, and relatively low-risk debt instruments.

2. *Capital Markets*

Capital markets include longer-term, relatively riskier securities.

Money Market Instruments

1. *Treasury Bills*

   - TBs are the most marketable of all money market instruments.
   - They represent the simplest form of borrowing.
   - The government raises money by selling bills to the public.
   - Investors buy the bills at a discount from the stated maturity value.
   - The difference between the purchase price and the ultimate maturity value represents the investor’s earnings.

2. *Certificates of Deposits (CDs)*

   - A CD is a time deposit with a bank.
   - Time deposits may not be withdrawn on demand.
   - The banks pay interest and principal to the depositor only at the end of the fixed term of the CDs.

3. *Commercial Paper*

   - Commercial papers are short term unsecured debt issued by large corporations.
   - Typical corporations are net borrowers of both long term funds (for capital investments) and short term funds (for working capital).
   - Thus, large and well known companies often issue their own short term unsecured debt notes directly to the public, rather than borrowing from the banks.
   - These notes are called commercial papers.
   - CPs are traded in secondary markets and are quite liquid.
4. Bankers’ Acceptances

They are orders to a bank made by a customer to pay a sum of money at a future date.

- BAs are also known as Post Dated Checks to be cashed within 6 months.
- Upon the acceptance of payment, BAs can be traded in secondary markets as well.
- BAs are widely used in foreign trade where the creditworthiness of one trader is unknown to the trading partner.

5. Eurodollars

Eurodollars are Dollar-denominated deposits at foreign banks or foreign branches of American banks.

- Most Eurodollar deposits are for large sums.
- Most are time deposits of less than six months’ maturity.
- A variation in Eurodollar time deposits is the Eurodollar certificate of deposit.
- The advantage of Eurodollar CD over Eurodollar time deposit is that the holder can sell the asset to realize its cash value before maturity.
- Eurodollar CDs are considered less liquid and riskier than domestic CDs, so offer higher yields.

6. REPOs and Reverses

Repurchase Agreements are overnight borrowing used by governments.

- The dealer sells securities to an investor on an overnight basis, with an agreement to buy back those securities the next day at a slightly higher price.
- The increase in the price is the overnight interest.
- A reverse REPO is the mirror image of a REPO.
- In Reverse REPO, the dealer finds an investor holding government securities and buys them with an agreement to resell them at a specified higher price on a future date.

7. Brokers’ Calls

Individuals who buy stocks on margin borrow part of the funds to pay for the stocks from their broker.

- The broker in turn may borrow part of the funds from a bank, agreeing to repay the bank immediately (on call) if the bank requests it.
• The rate paid on such loans is usually about one percentage point higher than the rate on short term T-bills.

8. **Federal Funds**

Just as most of people maintain deposits at banks, banks maintain deposits of their own at the Federal Reserve Banks (Central Banks).

• Each bank is required to maintain a minimum balance in a reserve account with central bank.
• The level of required balance depends on the total deposits of the bank`s customers. Funds in the bank`s reserve account are called Federal Funds (CB funds).

9. **The LIBOR Market**

The London Interbank Offer Rate (LIBOR) is the rate at which large banks in London are willing to lend money among themselves.

• This rate has become the premier short term interest rate quoted in the European money market and serves as a reference rate for a wide range of transactions.

10. **Yields on Money Market Instruments**

• Although most money market securities are of low risk, they are not risk free.
• Money market securities promise yields greater than those on default free T-bills, at least in part because of greater relative riskiness.
• Investors requiring more liquidity (cash) also will accept lower yields on securities such as T-bills, that can be more quickly and cheaply sold for cash.

**The Bond Market**

The Bond market is composed of longer-term borrowing or debt instruments than those that trade in the money market.

• This market includes Treasury notes and bonds, corporate bonds, municipal bonds, mortgage securities, and federal agency debt.
• These instruments are sometimes said to comprise the fixed-income capital market, because most of them promise either a fixed stream of income or stream of income that is determined according to a specified formula.
1. Treasury Notes and Bonds

These are debt obligations of governments with original maturities of one year or more.

- T-note maturities range up to 10 years.
- Both bonds and notes make semiannual interest payments called *coupon payments*.
- The only major distinction between T-notes and T-bonds is that T-bonds may be callable during a given period, usually the last five years of the bond’s life.

2. Federal Agency Debt

Some government agencies issue their own securities to finance their activities.

3. International Bonds

Many firms borrow abroad and many investors buy bonds from foreign issuers.

- A Eurobond is a bond denominated in a currency other than that of the country in which it is issued.
- For example, a dollar denominated bond sold in the UK.

4. Municipal Bonds

These are tax exempt bonds issued by state and local governments. The interest income is also exempt from taxation.

Two types of municipal bonds:

a. General obligation bonds: Backed by the full faith and credit (i.e. the taxing power).

b. Revenue bonds: Issued to finance particular projects and backed either by revenues from those projects or by the municipal agency operating the project.