

Introduction to

FINANCIAL SYSTEM



Syllabus

- **Unit 1: Overview of Financial System**
- An introduction to the financial system, Overview of financial system, Functions of a financial system.
- Evolution of financial systems (capital market oriented)
- Financial systems in India compared with those in developed nations and developing nations
- Constituents of the financial system and interrelationships between various components

Syllabus

- **UNIT 2: Financial Markets**
- Capital markets, Money Markets, Foreign Exchange Market, Commodity Markets, Derivative Markets Meaning, classification and structure, sub-segments, Role played, participants.
- **UNIT 3: Financial Regulators**
- Meaning and features of financial regulators, Role and functions of financial regulators, Kinds of financial regulators, markets regulated by each regulator

Syllabus

- **UNIT 4 :Financial Instruments and Financial Services**
- Meaning and classification of financial instruments (multiple ways of classifying financial instruments), Types of financial instruments, New Financial Instruments
- **Financial Services:**
- Meaning, Characteristics, Types of Financial Services(Fund based and Fee Based)

UNIT 1: Introduction to Financial System

- **What is financial system?**
- A financial system consist of institutional units and markets that interact, typically in a complex manner, for the purpose of mobilizing funds for investment, and providing facilities, including payment system, for financing of commercial activity.
- The collection of markets, institutions, laws, regulations, and techniques through which bonds, stocks, and other securities are traded, interest rates are determined, and financial services are produced and delivered around the world.

Financial System

- **Financial System**

Financial System is a mechanism that works for investors and people who want finance.

- Financial System is a key tool which supports the overall economic development of our country. It is the one which facilitates the smooth flow of funds between the households (savers) and businessmen (investors). The financial system of the country is one which promotes capital formation by channelizing the idle lying resources into useful means.

- **This system acts as an intermediary between the savers and investors.**

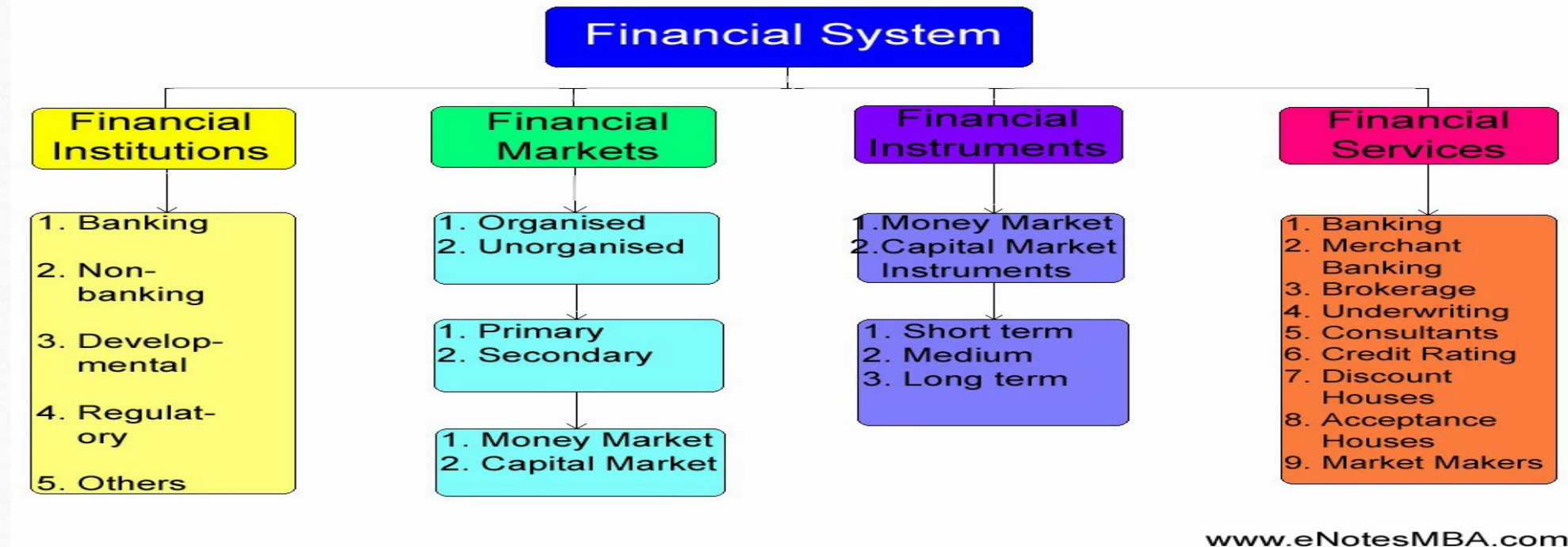
DEFINITIONS

- According to **Gurusamy** Financial System is *"a set of complex and closely interconnected financial institutions, markets, instruments, services, practises, and transactions."*
- According to **Amit Chaudhary**, *"Financial system is the integrated form of financial institutions, financial markets, financial securities and financial services which aim is to circulate the funds in an economy for economic growth."*
- According to **AMC**, *"Financial system is the set of interrelated and interconnected components consisting financial institutions, markets and securities."*

Features of Financial System

- It links Savers and Investors
- It encourages Savings and Investments
- It helps in Capital Formation
- It helps in allocation of risks
- It plays vital role in economic development of a nation
- It facilitates expansion of capital markets

Over view of Financial System



FUNCTIONS OF FINANCIAL SYSTEM

- **Function #1: Facilitating Payments**

- The transfer of goods and services can take place smoothly only if there is a mechanism in place to ensure that the payments reach in time. This function is carried out by the payments system. The payment system can be viewed as a subset of the financial system. It is composed of several institutions, such as banks, depository institutions, and private companies.
- These institutions pool in their services to provide convenience to users. As a result, users can use different mechanisms like a check, credit cards, and even wire transfers to pay for goods and services. The slow movement of money had been an impediment to trade and commerce for many years. However, now, with the advancement in technology, money can be transferred instantaneously to almost any part of the world.

FUNCTIONS OF FINANCIAL SYSTEM

- **Function #2: Transfer of Resources**
- The cash flow which individuals and companies have sometimes may not match with the cash flow that they desire. For instance, a retired person may have a lump sum of money. However, they may be more interested in a periodic sum of money. On the other hand, a company may want a significant sum of money upfront so that they can invest it in a project. In return, they may be willing to make a series of payments. Both of these tasks are accomplished through the financial system. The financial system allows investors to transform their resources and access it during a point of time that is convenient for them.

FUNCTIONS OF FINANCIAL SYSTEM

- **Function #3: Risk Management**
- The derivatives market and the insurance market are an important part of the financial system. These markets have been created with the sole purpose of rationalizing the risk, which is an inevitable part of the life of individuals as well as businesses.
- Using the financial system, individuals are able to pool in their resources and cover themselves in case any unforeseen event happens in their lives. In many countries, the government has created a social welfare system. This can also be seen as a system of insurance, which is a part of the larger financial system

FUNCTIONS OF FINANCIAL SYSTEM

- **Function #4: Managing Information**

- The financial system provides important information, which is important for the well-being of the economy as a whole. One of the most important information provided by the markets is about prices. The price information is the basis on which all of the economic theory has been developed. It is the basis on which all economic decisions are made.
- For instance, the law of demand as well as supply, both have a price as an important parameter. Hence, traders and other individuals use this information in order to decide the amount they will produce or buy. This means that the economy as a whole also rations its resources based on the price information. This mechanism is extremely important for the economy since it is this mechanism that enables maximum utilization of underlying resources and, therefore, maximum economic growth.
- Other prices like interest rates, foreign exchange rates, and even stock prices are important indicators. Individuals can cater to their investment plan based on the information received from the financial system.

FUNCTIONS OF FINANCIAL SYSTEM

- **Function #5: Efficient Middleman**
- The financial system plays the role of an efficient middleman. This is because the financial system allows the savings to be diverted towards productive activities with the least amount of transaction costs. The financial system consists of various systems that have been created, keeping in mind the needs of the specific markets. For instance, banks and debt holders based system has been created to fund infrastructure projects which continue over the long term. At the same time, equity-based securities have been created for investors who want to participate directly in the business by taking the associated risks

FUNCTIONS OF FINANCIAL SYSTEM

- **Function #6: Pooling of Resources**

- The financial system makes it possible for a group of investors to achieve what they could not have done individually. For instance, individual investors are limited by their knowledge when they start investing in stocks. However, when a group of investors gets together, the pool of funds becomes so large that they can afford to hire a team of specialists. This enables them to compete with the bigger funds on an equal footing. The ability to pool resources and deploy them safely is the hallmark of any financial system. All major financial systems and services like banking, insurance, and even mutual funds are the result of the proper discharge of this function.
- Therefore, it would be appropriate to say that financial systems perform a lot of functions that can be considered fundamental. If these functions are not discharged, the markets, as we know today would not exist.

Functions

- **Savings function.** The global system of financial markets and institutions provides a conduit for the public's savings.
- **Wealth function.** The financial instruments sold in the money and capital markets provide an excellent way to store wealth.
- **Liquidity function.** Financial markets provide liquidity for savers who hold financial instruments but are in need of money.

Functions

- **Credit function.** Global financial markets furnish credit to finance consumption and investment spending.
- **Payments function.** The global financial system provides a mechanism for making payments for goods and services, in the form of currency, checking accounts, debit cards, credit cards, digital cash, etc.
- **Risk protection function.** The financial markets offer protection against life, health, property, and income risks, by permitting individuals and institutions to engage in both risk-sharing and risk reduction. **Policy function.** The financial markets are a channel through which governments may attempt to stabilize the economy and avoid inflation.

Evolution of Financial System

- History of Indian financial system dates back even before the period when India got independence in the Year 1947. Evolution of Indian Financial system can be classified into 3 phases: –
- **Pre Independence Phase (Before 1947).**
- **Post-Independence Phase (1947-1991).**
- **The Liberalization Era (1991 and beyond).**

Pre- Independence Phase (Before 1947).

- During this phase, there was a large number of banks present in India . Establishment of Bank of Hindustan in the year 1770 in Calcutta marks the starting of the Indian financial system. The bank discontinued its services in 1832. There were various banks that evolved post to Hindustan banks such as General Bank of India (1786-1791) and Oudh commercial bank (1881-1958). However, these banks were not able to continue for a long.
- Few banks of the 19th century are existing even today such as Punjab National bank formed in 1894 and Allahabad bank formed in 1865. Three major banks of that time like Bank of Bengal, Bank of Madras and Bank of Bombay were merged as one body which was termed as Imperial Bank of India. This Imperial bank was later on renamed to State Bank of India.

Pre- Independence Phase (Before 1947).

- During this phase, The Bombay Stock Exchange(BSE) also established in 1875 it is Asia's first stock exchange. The BSE has helped develop India's capital markets, including the retail debt market, and has helped grow the Indian corporate sector
- Hilton Young Commission in year 1935 recommended the establishment of Reserve bank of India.
- This was a phase in which majority of small-sized banks failed to function properly and were unable to gain people's confidence. People were more involved with money lenders and unregulated players.

Post-Independence Phase (1947-1991).

- Post-independence period is characterized by the nationalization of banks. Majority of banks in India were privately owned at the time of independence and were serving only the big corporates.
- Rural population, small-scale industries and agriculture sector were still dependent on local money lenders. The government in order to overcome this situation decided to nationalize the banks under the Banking regulation act, 1949. RBI was nationalized in 1949 and later on, 14 commercial banks were nationalized in July 1969 during the tenure of Indira Gandhi.

Post-Independence Phase (1947-1991).

Year	Institution	
1949	RBI-RESERVE BANK OF INDIA	NATIONALISED
1948	IFCI-INDUSTRIAL FINANCE CORPORATION OF INDIA	LARGE INDUSTRIES
1955	ICICI-INDUSTRIAL CREDIT & INVESTMENT CORPORATION OF INDIA	PRIVATE CORPORATE SECTOR
1956	LIC-LIFE INSURANCE CORPORATION OF INDIA	NATIONALISED
1964	UTI-UNIT TRUST OF INDIA	MUTUAL FUND
1964-	IDBI-INDUSTRIAL DEVELOPMENT BANK OF INDIA	DEVELOPMENT BANK
1972	GIC-GENERAL INSURANCE CORPORATION OF INDIA	NATIONALISED

Post-Independence Phase (1947-1991).

- Narasimham committee in 1975 recommended the establishment of RRBs (Regional Rural Banks) for development of rural sector and providing services to unserved ones.
- There were several other specialized banks which were constituted during this period to support the development of the economy. These were like NABARD in 1982 for supporting agricultural-related activities, National housing bank in 1988 for the Housing sector, SIDBI in 1990 for assisting small-scale firms.
- Nationalization was a remarkable step in the banking industry of industry which boost the country growth. It was successful in gaining people's confidence in banking services and also smaller group were easily able to access capital from financial institutions post nationalization.

The Liberalization Era (1991 and beyond).

- Government-led industrial policy, with corresponding restrictions on private enterprise, was the dominant pattern of Indian economic development until the 1991 Indian economic crisis
- During this period, government opened up the economy ,with the introduction of NEP-1991 popular as **LPG-Liberalisation, Privatisation & Globalisation**
- RBI granted license to 10 private sector banks out of which only few notables survived like Axis Bank, HDFC Bank, DCB, ICICI and IndusInd Bank.
- In 1992 National Stock Exchange Established to provide fully automated electronic trading

The Liberalization Era (1991 and beyond).

- Since 1991 –Following notable changes took place:
- IFCI-Shifted to Financial Services
- IDBI- shifted towards promoting institutional infrastructural development in capital market
- ICICI- converted into commercial bank
- Credit Rating Agencies – Credit Rating Information Services of India Limited(CRISIL),Investment Information and Credit Rating Agency Limited (ICRA), and Credit Analysis & Research Limited(CARE) were established.

The Liberalization Era (1991 and beyond)

- India could not have reached where it has without changing its institutions. One major institutional change that happened was the shift from government control to independent regulators appointed by the government.
- Between 1991 and 2021, India has seen the creation of several new regulators—Securities and Exchange Board of India in 1992;
- Telecom Regulatory Authority of India in 1997; Insurance Regulatory Development Authority of India in 1999;
- Competition Commission of India in 2002;
- Pension Fund Regulatory and Development Authority of India in 2003.

Evolution & Growth of Stock Exchanges in India

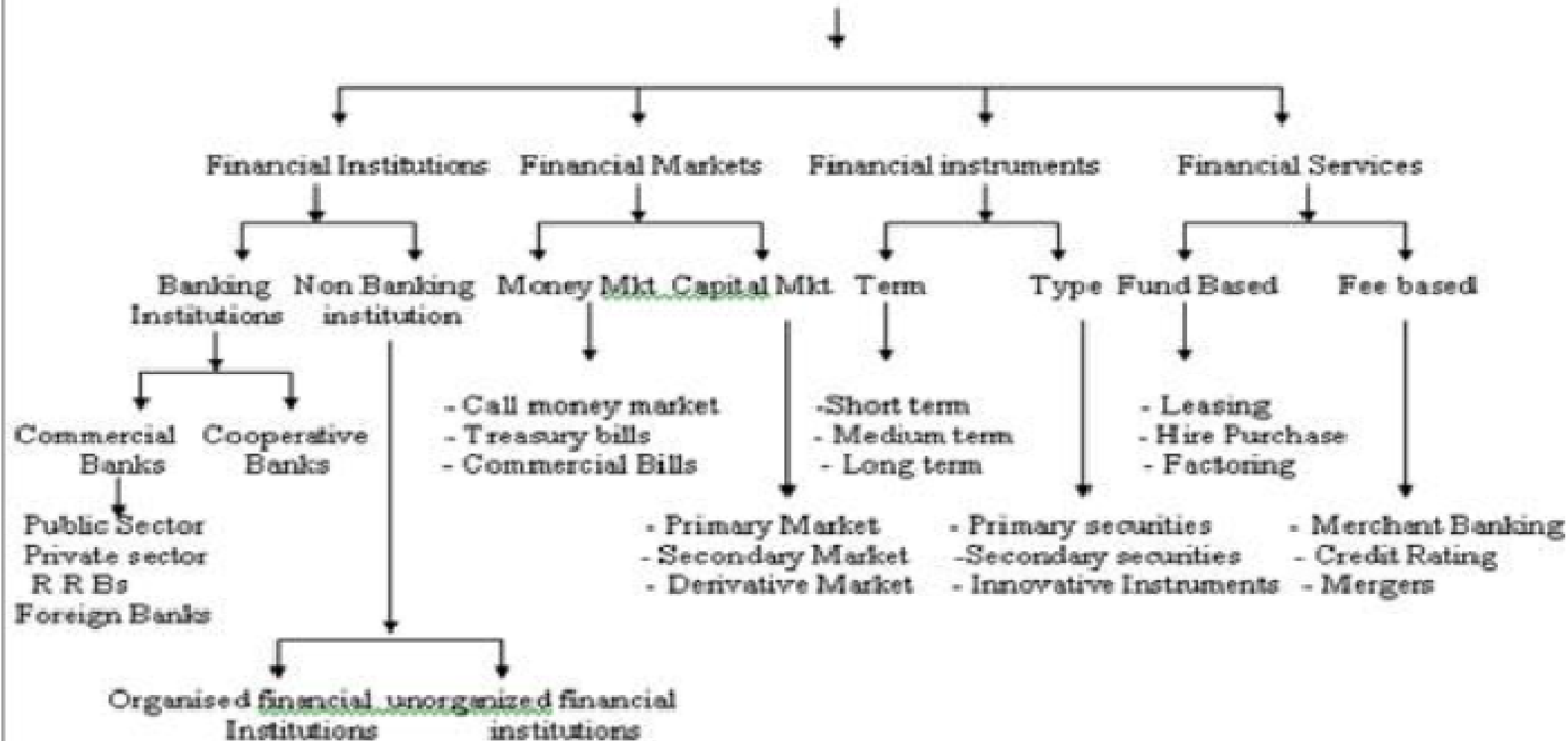
- 1850's-Rapid development of commercial enterprise saw brokerage business attracting more people into the business
- 1862-63-The number of brokers increased to about 200 to 250.
- 1875-"The Bombay Stock Exchange" was established in Bombay
- 1908"-The Calcutta Stock Exchange Association" was formed
- 1920- "The Madras Stock Exchange" was transacted with 100 brokers
- Most of the regional Exchanges were in a miserable state till 1957 when they applied for recognition under Securities Contracts (Regulations) Act, 1956

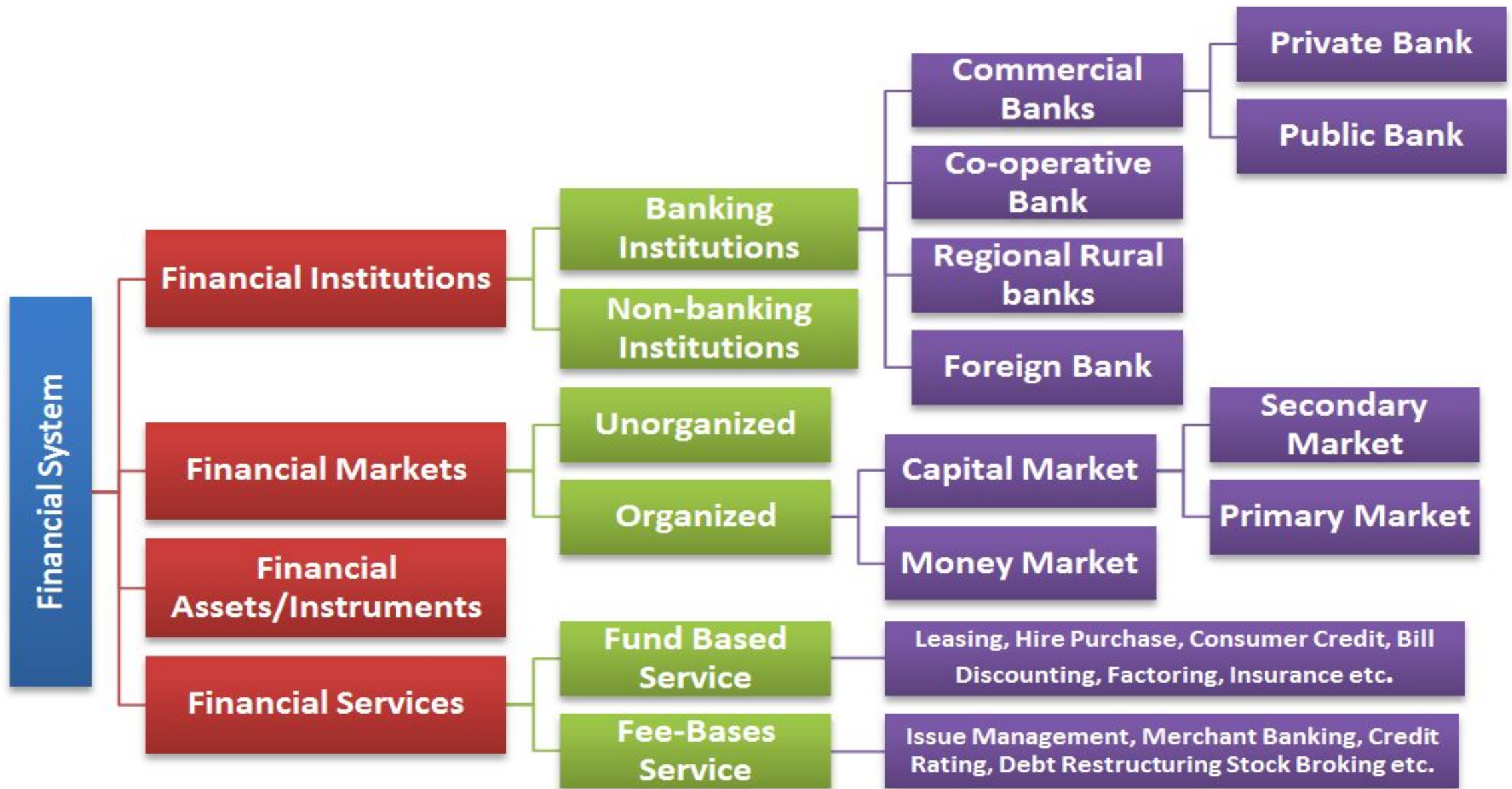
Evolution & Growth of Stock Exchanges in India

- This age-old trading mechanism in the Indian stock markets used to create many functional inefficiencies.
- Lack of liquidity and transparency, long settlement periods and benami transactions are a few examples that adversely affected investors.
- In order to overcome these inefficiencies, OTCEI was incorporated in 1990 under the Companies Act 1956.
- Scams in the market
- 1992 SEBI become a regulator
- NSE was incorporated in November 1992. In April 1993, it was recognized as a stock exchange.

Read: [Hamish McDonald's book "A Mahabharata in Polyester"](#)

COMPONENTS OF INDIAN FINANCIAL SYSTEM





Constituents/Components of Financial System

- There are basically **Four** components of Indian financial systems.
- **Financial Institutions**
 - Banking Institutions
 - Non-Banking Institutions
 - Regulatory Institutions
- **Financial Markets**
 - Money Market
 - Capital Market
 - Forex Market
 - Commodity Market

Constituents/Components of Financial System

- **Financial Instruments**
 - Money Market Instruments
 - Capital Market Instruments
 - Derivative Instruments
- **Financial Services**
 - General Banking Services
 - Insurance Services
 - Investment Services
 - Foreign Exchange Services

1) Financial Institutions

- The first component of the financial system is financial institutions. The financial institutions are *private or government entities* which offer several services to the general public and businesses for the management of funds.
- The financial institutions work as an intermediary between depositors/ investors (who have surplus funds) and borrowers (who require funds). Thus financial institutions fulfill the gap between lenders and borrowers.
- For instance, commercial banks, cooperative banks, insurance companies, stock brokers, mutual funds companies are some examples of financial institutions

1) Financial Institutions

- The financial institutions can be of three types.
- **Banking Institutions:** The banking institutions are those which accept deposits as well as distribute loans to the individuals and businesses.
- **Non-Banking Institutions:** Non banking institutions don't accept deposits (cash) from the public but offer various financial products and services to their customers. The insurance companies, mutual funds agencies , stock brokers and primary dealers are few examples of non banking institutions.
- **Financial Regulators:**RBI,IRDAI,SEBI,PFRDA

1) Financial Institutions

- Financial Regulators refers to the government bodies which are responsible for regulating, inspecting, monitoring the functions of various financial institutions like banks, insurance companies, business entities, Non-banking financial companies (NBFCs) etc.
- Financial Regulators are the apex bodies of financial institutions of respective sectors which register and functions under these financial regulatory institutions. Few examples of financial regulators in India are below.
- RBI (Reserve Bank of India)
- IRDA (Insurance Regulatory and Development Authority)
- SEBI (Securities Exchange Board of India)
- PFRDA (Pension Fund Regulatory and Development Authorit

2) Financial Market

- 2) Financial Market
- The financial market is the marketplace where the actual transactions of financial instruments take place between two persons/ parties. The financial markets can be broadly divided into different categories.
- 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.

2) Financial Market

- **Capital Market** : It is the marketplace where the long term securities(maturity period is more than a year) like stocks, bonds, debentures are issued and traded. Bombay Stock Exchange (BSE), NSE (National Stock Exchange), NYSE (New York Stock Exchange) are some examples of the capital market. It can be further classified into three categories.
 - Primary market
 - Secondary market
 - Derivative Market
- **Forex Market** : It deals with exchange of foreign currencies and determines the rate of exchange of currencies as well.
- **Commodity Market** : It basically deals with commodities like gold, silver, crude oils etc.

2) Financial Market

- **Organised Market:** Which is governed by rules and regulations.
- **Unorganised Market:** Operations in this market is not standardised, not controlled by regulators. Example-Chit Funds
- **Primary Market:** Also termed as New Issue Market, helps the corporates to raise funds. IPO's are offered through it.
- **Secondary Market:** Popularly called as stock market. It is the market for second hand securities.

3) Financial Instruments:

- 3) Financial Instruments:
- A financial instrument refers to a monetary document/ contract between two parties which are traded in the financial markets (Money market, capital market or derivative market). It represents an asset of one party and at the same time, the liability of another party.
- The financial instruments can be classified as follows:

Money Market Instruments:

- **Certificate of Deposit :** It is the dematerialised form of funds lent to the corporations for stipulated time period against interest earning. The operating procedures are the same as fixed deposits (FDs) provided any special negotiation.
- **Commercial Papers :** It is unsecured short term debt instruments usually having maturity period (7days to 1year) typically issued by large cap companies for the purpose of fundraising.
- **Treasury Bills :** It also short term debt instruments issued by the central Government of India only having maturity period upto 1year.

Money Market Instruments:

- **Repurchase Agreement (Repo) :** The commercial banks and other financial institutions borrow funds from the Reserve Bank of India for a shorter time (Overnight) through Repurchase Agreement by selling government approved securities with a promise to repurchase in future date.
- **Call Money :** Whenever a loan is granted for one day and has to be repaid the next day, it is known as call money.
- **Commercial Bills :** The commercial Bills are also traded in the money market and utilised to raise funds against receivables (Due payments). Such practice of raising funds at a discount is called bill/ invoice discounting.
- **Banker's Acceptance :** It is another money market instrument which are widely used in the financial market. A banker's acceptance refers to the extension of loan to the stipulated banks against a signed guarantee of repayment in future.

Capital Market Instruments:

- The capital market instrument refers to the long term capital financing instrument (debt and equity) traded on the recognised stock exchanges. The corporations issue such financial instruments to raise long term funds from the general public.
- Equity Shares
- Preference Shares
- Debentures
- Corporate Bonds

Derivative Instruments:

- The derivatives are those financial instruments which don't have their own value; instead it's value is derived from underlying assets. It is utilised to hedge the risk associated with price fluctuations of the securities.
- Forward
- Futures
- Options
- Swaps

4) Financial Services:

- The services offered by the financial institutions for the management, lending, borrowing and investment of funds are called financial services.
- **General Banking Services** : The services offered by the commercial banks or other banking institutions such as deposit of money, granting loans/ advances, Bill discounting, credit/ debit card, account opening etc.
- **Insurance Services** : The various insurance policies like life insurance, health insurance, car insurance etc are sold under these kinds of services.
- **Investment Services** : The various financial institutions such as stock brokers, merchant and investment bankers, primary dealers provide investment and asset management services to the businesses and corporations

4) Financial Services:

- Loan syndication
- Underwriting of securities
- Trading of stocks and other securities
- Mergers and acquisitions
- Fundraising services
- Depository services
- Online share trading
- Credit rating services
- **Foreign Exchange Services** : These are the special services which deal in exchange of foreign currencies

Inter relationship Between Financial System Components

- Interdependent
- Interactive
- Close links
- Competing with each other
- **Financial Institutions** mobilise savings by issuing different types of **Financial Instruments** which are traded in the **Financial Markets**. To facilitate these, financial institutions acquire specialisation and provide render specialised **Financial Services**

Financial System in India in comparison with Other Nations

- Financial systems in the various countries can be of

Bank Based Financial System or Market Based Financial System

In Bank Based Financial Systems, banks play a leading role in mobilising savings, allocating capital, overseeing investment decisions.

In Market Based Financial System, securities market share centre stage with banks in terms of getting society's savings to firms, exerting control.

**Indian Financial System is bank based like Germany & Japan,
American and British system are Market Based Financial system**

Comparision Bases of Financial System

- The difference in financial system can be compared on the following bases
- 1.Intermediaries
- 2.Equity Markets
- 3.Non banking financial intermediaries
- 4.Overall Efficiency
- 5.Financial Structure
- 6.Size of stock markets
- 7.Regulatory environment

Challenges of Indian Financial System

- Government Interference
- Lack of Professionalism
- Lack of Operational flexibility
- Lack of Coordination
- Lack of Transparency