Introduction to Financial System

Financial System

Financial system refers to a set of complex and closely connected or interlinked financial institutions or organised and unorganised financial markets, financial instruments and services which facilitate the transfer of fund.

Or

A financial system is that which covers financial transactions and exchange of money between investors, lenders and borrowers.

Objectives of Financial System

- To mobilise the resources.
- To create link between savers and investors
- To establish a regular smooth and efficient markets.
- To encourage savings and investment.
- To facilitate economic development of country
- To facilitate for expansion of financial markets.
- To make sound decisions based on cash flow and available resources.

Functions of Financial System

- **Provision of liquidity**
- **Mobility of savings**
- **Size transformation function**
- **Maturity transformation function**
- **Risk transformation function**

FUNCTIONS OF FINANCIAL SYSTEM

1. Provision of liquidity: it is the primary function, it states the ability of meeting the obligations as and when required, it is the ability of converting assets into liquid cash.
2. Mobility of savings: helps in mobilising savings from savers to investors.
3. Size transformation function(small savings to big investment): it channelizes small fund received from the savings group to the industries for the purpose of investment

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4. Maturity transformation function: The financial intermediaries accept deposits from public in different maturities according to their liquidity preference and lend them to the borrowers in different maturities according to their need and promote the economic activities of a country.
5. Risk Transformation Function: financial institutions takes the function of risk in investing their fund in profitable and safe ventures by bearing the risk.

FINANCIAL CONCEPTS

I. Financial Assets
II. Financial Intermediaries
III. Financial Markets/rate of return
IV. Financial Instruments
V. Financial Services

Financial Assets

- Financial Assets Is One Which Is Used For Production Or Consumption Or For Further Creation Of Assets

Eg: A Buys Equity Shares And These Shares Are Termed As Financial Assets As They Earn Income In Return(dividend And Interest)

Eg: Building : Own Purpose : Physical Asset

For Hiring: Financial Asset

Classification of financial assets

- Financial Assets
  - Marketable Assets
    - Shares
    - Government Securities
    - Bonds
    - Mutual Funds Units
    - UTI Units
    - Bearer Debentures
  - Non Marketable Assets
    - Bank Deposits
    - Provident Fund
    - LIC Schemes
    - Commission Deposits
    - Post Office Certificates

1.Marketable Assets

Marketable assets are those which can be easily transferred from one person to another person without much hindrance and restrictions

Eg: shares of listed companies, government securities, bonds of public sector undertaking

2. Non Marketable Assets

If assets cannot be transferred easily , it is termed as non marketable assets

Eg: Bank Deposits, provident fund, national savings certificate, insurance policies etc

Other Kinds Of Financial Assets

- *Cash Assets*
- *Debt Assets*
- *Stock Assets*

CASH ASSETS

In India, all coins and currencies are issued by RBI.

But, when a loan is sanctioned for the customer, Liquid cash is not granted, instead an account is opened in the borrowers name and a deposit is created, it is also called money assets.

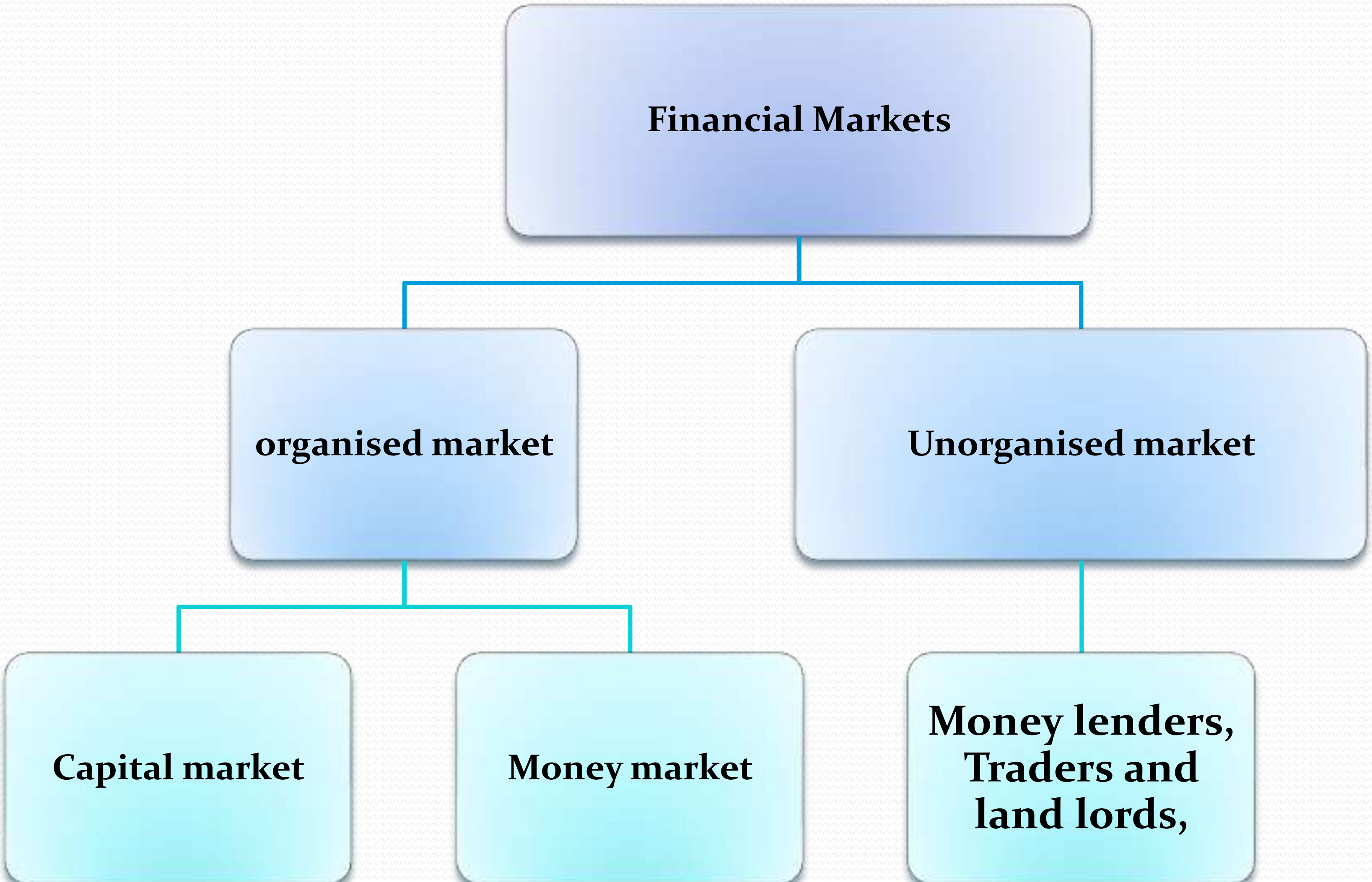
DEBT ASSETS

- Debt assets is issued by various organisations, for the purpose of raising debt capital
- It has a fixed repayment schedule with regard to interest and principal
- Eg: issue of debentures, raising of term loans, working capital advances

STOCK ASSETS

- It is issued by business organisations for raising their fixed capital
- There are two types of stocks/shares: Equity and Preference
- Equity shares holders are the owners of the company, they will have the risk and profits
- Preference share holders are given the preference in payment of dividends at fixed rate

II. Financial Markets



- Capital market
  - Industrial securities Market
  - Govt. Securities Market
  - Long term loans market

- Money market
  - Call Money Market
  - Commercial Bill Market
  - Government (treasury bills)
  - Short term loan Market

II. Financial Markets

- Financial market is a place or location where many financial transactions takes place.
- There is no specific place or location to indicate financial market
- It includes issue of equity shares, granting of loans by term lending institutions, deposit of money into banks, purchase of debentures, sale of shares

UNORGANISED MARKET

- It includes money lenders, indigenous bankers, traders who lend money to the public and are not controlled by RBI.
- The regulations concerning these financial dealings are inadequate and the financial instruments are not standardised.

Organised markets

- In organised markets , there are standardised rules and regulations governing their financial findings
- They have strict supervision and control by RBI and other regulatory authorities
- They include:

Capital Market

Money Market

CAPITAL MARKET

- It deals with those financial assets which have a long or indefinite maturity
- It deals with long term securities which have a maturity period of above one year.

It is further divided into :

Industrial securities market

Government securities market

Long term loans market

Industrial Securities Market

- It deals with industrial securities
- Namely: **Equity Shares Or Ordinary Shares**

  Preference Shares

  Debentures Or Bonds

It is further divided into

Primary market

Secondary market or stock exchange

Primary Market: Primary market is a market for new issues hence it is called new issue market. The primary market deals with those securities which are issued to the public for first time.

Secondary market: secondary market is a market for secondary sale of securities. In other world securities which are already issued are traded in this market.

Government securities market

- It is also called Gilt- edged securities market
- It is a market where government securities are traded
- Government securities are issued in denominations of Rs 100.interest is payable half yearly and they carry tax exemption.
- Eg: ***stock certificates***

Promissory notes

Bearer bonds

- Government securities are sold through the public debt office of the RBI, while treasury bills are sold through auctions

Long Term Loans Market

- Term loans market
- Mortgages market
- Financial guarantees market

Term loans market

- They supply long term and medium term loans to customers directly as well as indirectly
- Institutions like IDBI, IFCI, ICICI and other state financial corporations come under this category
- These institutions meet the growing and varied long term financial requirements of industries by supplying long term loans
- They also help in identifying opportunities, encourage new entrepreneurs and supports modernisation efforts

Mortgages market

- It refers to those centres which supply mortgage loan mainly to individual customers
- 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
- The housing and urban development corporation and LIC plays a dominant role in financing residential projects

Financial guarantees market

- A guarantee market is a centre where finance is provided against the guarantee of a reputed person
- Guarantee is a contract to discharge the liability of a third party in case of his default
- In case the borrower fails to repay the loan, the liability falls on the shoulders of the guarantor
- Hence the guarantor must be known to both the borrower and the lender , lender should have the means to discharge his liability

- Types of guarantee

- Performance guarantee
- Financial guarantee

These guarantees are provided mainly by commercial banks, development banks, ECGC(export credit guaranteed corporation), DICGC(deposit insurance and credit guarantee corporation)

2.Money market(short term loans)

- It Is a market for the lending and borrowing of short term funds
- It includes trade bills, promissory notes and government papers drawn for a short period not exceeding one year
- No personal contact or presence is essential for negotiations in money market

Functions of money market

- It is a market for short term funds
- It has a maturity period of one year
- It deals with only those assets which can be converted into cash without any loss, with minimum transaction cost.
- Generally, transactions takes place through phone i.e oral communication. There is no formal place like stock exchange as in the case of capital market
- There are no brokers involved in money markets

Objectives of money market

- Helps to overcome short term deficits
- To enable the central banks to influence and regulate liquidity in the economy through its interventions in this market
- To provide a reasonable access to users of short term funds to meet their requirements quickly, adequately and at reasonable costs

Importance Of Money Market

- Importance
  - Development of trade and industry
  - Development of capital markets
  - Smooth functioning of commercial banks
  - Effective central bank control
  - Formulation of suitable monetary policy
  - Non inflationary source of finance to government

Composition Of Money Market

Composition of money market

- **Call money market**
- **Commercial bills market**
- **Treasury bills**
- **Shot term loan market**

Call Money Market

- It deals with short term lending of loans
- **From one day to fourteen days**
- It has good liquidity
- They loans are repayable on demand at the option of either lender or the borrower
- It is associated with the presence of stock exchange
- The interest varies from day to day and even from hour to hour
- It is very sensitive to changes in demand and supply of call loans

Commercial Bills Market

- It is a market for bills of exchange arising out of genuine trade transactions
- In case of sale, the trader may draw bills of exchange on the buyer
- **The buyer accepts the bill promising to pay at a later date specified in the bill**
- **The seller did not wait for the due date, instead he can get immediate payment on discounting the bill**

Treasury Bills Market

- A treasury bill is a promissory note or a finance bill issued by the government
- It is a important instrument for short term borrowings of the government
- Treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the central government to meet its short term financial needs
- **Treasury bills have a maturity period of 91 days, 182 days, 364 days.**

Short Term Loan Market

- It is a market where short term loans are given to corporate customers for meeting their working capital requirement
- Commercial banks provide **short term loans** in the form of cash credit and overdraft
- Overdraft facility is given to business people
- Cash credit is given to industrialists