LESSON 2: THE FINANCIAL SYSTEM

Lesson Objectives

To understand the Functions of Financial System,Finantial Assets, Intermediaries and Markets.

The economic development of any country depends upon the existence of a well organized financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promotes the well being and standard of living of the people of a country. Thus, the 'financial system' is a broader term which brings under its fold the financial markets and the financial institutions which support the system.

The major assets traded in the financial system are money and monetary assets. The responsibility of the financial system is to mobilize the savings in the form of money and monetary assets and invest them to productive ventures. An efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development.

Functions of The Financial System

As we know, financial system is very important for the economic and all round development of any country, its major functions can be explained as following :

1 Promotion of Liquidity

The major function of the financial system is the provision of money and monetary assets for the production of goods and services. There should not be any shortage of money for productive ventures. In financial language, the money and monetary assets are referred to as liquidity. In other words, the liquidity refers to cash or money and other assets which can be converted into cash readily without loss. Hence, all activities in a financial system are related to liquidity – either provision of liquidity or trading in liquidity.

2 Mobilization of Savings

Another important activity of the financial system is to mobilize savings and channelise them into productive activities. The financial system should offer appropriate incentives to attract savings and make them available for more productive ventures. Thus, the financial system facilitates the transformation of savings into investment and consumption. The financial intermediaries have to play a dominant role in this activity.

Financial Concepts

An understanding of the financial system requires an understanding of the following concepts :

1. Financial Assets
2. Financial Intermediaries
3. Financial markets
4. Financial rates of returns
5. Financial instruments

Financial Assets

In any financial transaction, there should be a creation or transfer of financial asset. Hence, the basic product of any financial system is the financial asset. A financial asset is one, which is used for production or consumption or for further creation of assets. For instance, A buys equity shares and these shares are financial assets since they earn income in future.

One must know the distinction between financial assets and physical assets. Unlike financial assets, physical assets are not useful for further production of goods or for earning incomes. It is interesting to note that the objective of investment decides the nature of assets. For instance, if a building is bought for residence purposes, it becomes a physical asset, if the same is bought for hiring it becomes a financial asset.

Classification of Financial Assets

Financial assets can be classified differently under different circumstances. Like :

A. (i) Marketable assets and (ii) Non-marketable assets

B. (i) Money/cash asset (ii) Debt asset and (iii) Stock assets

Marketable Assets : Marketable assets are those which can be easily transferred from one person to another without much hindrance. Example – Equity shares of listed companies, Bonds of PSUs, Government Securities.

Non-marketable Assets : If the assets cannot be transferred easily, they come under this category. Example : FDRs, PF, Pension Funds, NSC, Insurance policy etc.

Cash Assets : All coins and currencies issued by the Government or Central Bank are cash assets. Besides, commercial banks can also create money by means of creating credit.

Debt Asset : Debt asset is issued by a variety of organizations for the purpose of raising their debt capital. There are different ways of raising debt capital. Ex.- issue of debentures, raising of term loans, working capital advances etc.

Stock Asset : Stock is issued by business organizations for the purpose of raising their fixed capital. There are two types of stock namely equity and preference.

Financial Intermediaries

The term financial intermediaries includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers. Thus, it refers to all kinds of FIs and investing institutions which facilitate financial transactions in financial markets. They may be in the organized sector or in the unorganized sector. They may also be classified in to two :

i. Capital Market Intermediaries

ii. Money Market Intermediaries.

Capital Market Intermediaries

These intermediaries mainly provide long term funds to individuals and corporate customers. They consist of term lending institutions like financial corporations and investment institutions like LIC.

Money Market Intermediaries

Money market intermediaries supply only short term funds to individuals and corporate customers. They consist of commercial banks, cooperative bank.

Financial Markets

Generally speaking, there is no specific place or location to indicate a financial market. Wherever a financial transaction takes place it is deemed to have taken place in the financial market. Hence financial markets are pervasive in nature since financial transactions are themselves very pervasive throughout the economic system. However, financial markets can be referred to as those centers and arrangements which facilitate buying and selling of financial assets, claims and services. Sometimes, we do find the existence of a specific place or location for a financial market as in the case of stock exchange.

Classification of Financial Markets

The classification of financial markets in India can be as following :

Unorganized Markets : In unorganized markets, there are a number of money lenders, indigenous bankers, traders, etc. who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc whose activities are not controlled by the RBI. The RBI has already taken some steps to bring unorganized sector under the organized fold.

Organized Markets : In the organized markets, there are standardized rules and regulations governing their financial dealings. There is also a high degree of institutionalization and instrumentalization. These markets are subject to strict supervision and control by the RBI or other regulatory bodies. These organized markets can be further classified into two. They are

i. Capital Market and

ii. Money Market.

Capital Market

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three, namely :

1. Industrial Securities Market
2. Government Securities Market and
3. Long-term Loans Market.

1 Industrial Securities Market

As the very name implies, it is a market for industrial securities, namely : (i) equity shares (ii) Preference shares and (iii) Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are

a. Primary market or New Issue Market,

b. Secondary market or Stock Exchange.

Primary Market : Primary market is a market for new issues or new financial claims. Hence it is also called New Issue Market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, primary market facilitates capital formation.
There are three ways by which a company may raise capital in a primary market. They are (i) Public issue (ii) Right issue and (iii) Private placement.

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

Secondary Market : Is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market. Generally, such securities are quoted in the stock exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognized by the Government.

2 Government Securities Market

It is otherwise called Gilt-Edged securities market. It is a market where government securities are traded. In India there are many kinds of Government securities – short term and long term. Long-term securities are traded in this market while short term securities are traded in money market.

The secondary market for these securities is very narrow since most of the institutional investors tend to retain these securities until maturity.

3 Long-term Loans Market

Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers. Long term loans market may further be classified into – (i) Term loans, (ii) Mortgages and (iii) Financial Guarantees markets.