UNIT I
INTRODUCTION

1. What is financial system? State its features.

Ans. A financial system refers to a system which enables the transfer of money between investors and borrowers. A financial system could be defined at an international, regional or organization level. The term “system” in “Financial System” indicates a group of complex and closely linked institutions, agents, procedures, markets, transactions, claims and liabilities within an economy.

Features of financial system

The features of the financial system are as follows:

(1) Financial Institutions: Under financial system there are numerous institutions and these institutions collect the public saving with themselves and encourage the public for saving and also provide credit to the needy persons

(2) Financial Process: Under Financial system, capital is formed by the process of finance. This process can be explained in this way:

Income → Saving → Investment → Capital Formation.

(3) Parts of Financial System: Banks, insurance companies, Unit Trust of India and other such financial institutions are a part of financial system. Through these institution using various plans and medium, interest are created among the people. Financial system renders its services to both lender and borrower.

(4) Stability in Money Market: Just like commodity, fluctuation also takes place in the value of money. Due to maximum fluctuation the prosperity of the country can be damaged. Thus strong financial system brings stability in money market.

(5) Liquidity: Through financial system wealth is converted into liquid money and is used in those areas where maximum profit can be extracted.

1. Give an overview of Financial System in India.
Or
Explain the components of financial system.

Ans. The services that are provided to a person by the various Financial Institutions including banks, insurance companies, pensions, funds, etc. constitute the financial system.
The financial system of a country mainly aims at managing and governing the mechanism of production, distribution, exchange and holding of financial assets or instruments of all kinds.

There are four main components of the Indian Financial System. This includes:

1. Financial Institutions
2. Financial Assets

3. Financial Services
4. Financial Markets

Let's discuss each component of the system in detail.

1. Financial Institutions: The Financial Institutions act as a mediator between the investor and the borrower. The investor's savings are mobilised either directly or indirectly via the Financial Markets.

The main functions of the Financial Institutions are as follows:

- A short term liability can be converted into a long term investment
- It helps in conversion of a risky investment into a risk-free investment
- Also acts as a medium of convenience denomination, which means, it can match a small deposit with large loans and a large deposit with small loans

The best example of a Financial Institution is a Bank. People with surplus amounts of money make savings in their accounts, and people in dire need of money take loans. The bank acts as an intermediate between the two.

The financial institutions can further be divided into two types:

(i)Banking Institutions or Depository Institutions – This includes banks and other credit unions which collect money from the public against interest provided on the deposits made and lend that money to the ones in need

(ii)Non-Banking Institutions or Non-Depository Institutions – Insurance, mutual funds and brokerage companies fall under this category. They cannot ask for monetary deposits but sell financial products to their customers.

Further, Financial Institutions can be classified into three categories:

(i)Regulatory – Institutes that regulate the financial markets like RBI, IRDA, SEBI, etc.

(ii)Intermediates – Commercial banks which provide loans and other financial assistance such as SBI, BOB, PNB, etc.

(iii)Non Intermediates – Institutions that provide financial aid to corporate customers. It includes NABARD, SIBDI, etc.

2. Financial Instruments/Assets: Financial Instruments can be defined as a market for short-term money and financial assets that is a substitute for money. The term short-term means generally a period of one year substitutes for money is used to denote any financial asset which can be quickly converted into money. Some of the important instruments are as follows:

(i)Call /Notice-Money: The money market primarily facilitates lending and borrowing of funds between banks and entities like Primary Dealers (PDs). Banks and PDs borrow and lend overnight or for the short period to meet their short term mismatches in fund positions. This borrowing and lending is on unsecured basis. 'Call Money' is the borrowing or lending of funds for 1day. Intervening holidays and Sunday are excluded for this purpose. Thus money borrowed on a day and repaid on the next working day is Call Money. Where money is borrowed or lend for period between 2 days and 14 days it is known as 'Notice Money'. And 'Term Money' refers to borrowing/lending of funds for period exceeding 14 days.

(ii)Term Money: Deposits with maturity period beyond 14 days and upto one year is referred to as the term money. The entry restrictions are the same as that of Call/Notice Money, the specified entities not allowed to lend beyond 14 days.

(iii)Treasury Bills: Treasury Bills are short-term (up to one year) borrowing instruments of the union government. It's a promise by the Government to pay the stated sum after the expiry of the stated period from the date of issue (less than one year). They are issued at a discount off the face value and on maturity; the face value is paid to the holder.

(iv)Certificate of Deposits: Certificates of Deposits is a money market instrument issued in dematerialised form or as a Promissory Note for funds deposited at a bank, other eligible financial institution for a specified period.

(v)Commercial Paper: CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt is transformed into an instrument. CP is an unsecured promissory note privately placed with investors at a discount rate of face value determined by market forces.

3. Financial Services: Services provided by Asset Management and Liability Management Companies. They help to get the required funds and also make sure that they are efficiently invested.

The financial services in India include:

(i)Banking Services – Any small or big service provided by banks like granting a loan, depositing money, issuing debit/credit cards, opening accounts, etc.

(iii)Insurance Services – Services like issuing of insurance, selling policies, insurance undertaking and brokerages, etc. are all a part of the Insurance services

(iv)Investment Services – It mostly includes asset management

(v)Foreign Exchange Services – Exchange of currency, foreign exchange, etc. are a part of the Foreign exchange services

The main aim of the financial services is to assist a person with selling, borrowing or purchasing securities, allowing payments and settlements and lending and investing.

4. Financial Markets: The marketplace where buyers and sellers interact with each other and participate in the trading of money, bonds, shares and other assets is called a financial market.

The financial market can be further divided into four types:

(i)Capital Market – Designed to finance the long term investment, the Capital market deals with transactions which are taking place in the market for over a year. The capital market can further be divided into three types:

(a) Corporate Securities Market

(b) Government Securities Market

(c) Long Term Loan Market

(ii)Money Market – Mostly dominated by Government, Banks and other Large Institutions, the type of market is authorised for small-term investments only. It is a wholesale debt market which works on low-risk and highly liquid instruments. The money market can further be divided into two types:

(a)Unorganized Market: It consists of Moneylenders, Indigenous Bankers, Chit Funds, etc.

(b)Organized Money Market: It consists of Treasury Bills, Commercial Paper, Certificate Of Deposit, Call Money Market and Commercial Bill Market. Organised Markets work as per the rules and regulations of RBI. RBI controls the Organized Financial Market in India.

(iii)Foreign exchange Market – One of the most developed markets across the world, the Foreign exchange market, deals with the requirements related to multi-currency. The transfer of funds in this market takes place based on the foreign currency rate.

(iv)Credit Market – A market where short-term and long-term loans are granted to individuals or Organisations by various banks and Financial and Non-Financial Institutions is called Credit Market.

3. Give an overview of Financial Markets in India.

Ans. 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.
The marketplace where buyers and sellers interact with each other and participate in the trading of money, bonds, shares and other assets is called a financial market.
The financial market can be further divided into four types:

(I)Capital Market – Designed to finance the long term investment, the Capital market deals with transactions which are taking place in the market for over a year. The capital market can further be divided into three types:

(i)Corporate Securities Market: 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: 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.

(b)Secondary market or stock exchange: Secondary market is a market for secondary sale of securities. In other words securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the Stock Exchange and it provides a continuous and regular market for buying and selling of securities.

(ii)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 the money market.

(iii)Long Term Loan 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.

(a)Term loans market: Institutions like IRBI, IFCI, and other state financial corporation's come under this category. These institutions meet the growing and varied long-term financial requirements of industries meet the growing and varied long-term financial requirements of industries by supplying long-term loans.

(b)Mortgages Market: The mortgages market refers to those centres which supply mortgage loan mainly to individual customers.
The mortgage market may have primary market as well as secondary market. The primary market consists of original extension of credit and secondary market has sales and resales of existing mortgages at prevailing prices.

(c) Financial guarantees market: A guarantee Market is a centre where finance is provided against the guarantee of a reputed person in the financial circle.

(II)Money Market – Mostly dominated by Government, Banks and other Large Institutions, the type of market is authorised for small-term investments only. It is a wholesale debt market which works on low-risk and highly liquid instruments. The money market can further be divided into two types:

(i)Unorganized Market: It consists of Moneylenders, Indigenous Bankers, Chit Funds, etc.

(ii)Organized Money Market: It consists of Treasury Bills, Commercial Paper, Certificate Of Deposit, Call Money Market and Commercial Bill Market. Organised Markets work as per the rules and regulations of RBI. RBI controls the Organized Financial Market in India. These are discussed below:

(i)Call /Notice-Money: Call/Notice money is the money borrowed on demand for a very short period. When money is lent for a day it is known as Call Money. Intervening holidays and Sunday are excluded for this purpose. Thus money borrowed on a day and repaid on the next working day is Call Money. When the money is borrowed or lent for more than a day up to 14 days it is called Notice Money. No collateral security is required to cover these transactions.

(ii)Term Money: Deposits with maturity period beyond 14 days is referred to as the term money. The entry restrictions are the same as that of Call/Notice Money, the specified entities not allowed to lend beyond 14 days.

(iii)Treasury Bills: Treasury Bills are short-term (up to one year) borrowing instruments of the union government. It's a promise by the Government to pay the stated sum after the expiry of the stated period from the date of issue (less than one year). They are issued at a discount off the face value and on maturity, the face value is paid to the holder.

(iv)Certificate of Deposits: Certificates of Deposits is a money market instrument issued in dematerialised form or as a Promissory Note for funds deposited at a bank, other eligible financial institution for a specified period.

(v)Commercial Paper: CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt is transformed into an instrument. CP is an unsecured promissory note privately placed with investors at a discount rate of face value determined by market forces.

(III)Foreign exchange Market – One of the most developed markets across the world, the Foreign exchange market, deals with the requirements related to multi-currency. The transfer of funds in this market takes place based on the foreign currency rate.

(IV)Credit Market – A market where short-term and long-term loans are granted to individuals or Organisations by various banks and Financial and Non-Financial Institutions is called Credit Market.

4. What do you mean by financial intermediary? Explain the different types of financial intermediary.

Ans. Financial intermediary is the organization which acts as a link between the investor and the borrower, to meet the financial objectives of both the parties. These can be seen as business entities which accept deposits from the depositors or investors (lenders) by allowing them low interest on their sum. Further, these organizations, lend this amount to the individuals and firms (borrowers) at a comparatively high rate of interest to make their margin.

Types of Financial Intermediaries

There are several financial intermediaries formed to serve the different aims and objectives of the customers or members or lenders and borrowers. These entities are explained in detail below:

(i)Banks: The central and commercial banks are the most well known financial intermediaries simplifying the lending and borrowing process, along with providing various other services to its customers on a large scale.

(ii)Credit Unions: These are the cooperative financial units which facilitate lending and borrowing of funds to provide financial assistance to its members.

(iii)Non-Banking Finance Companies: A NBFC is a financial company engaged in activities such as advancing loans to its clients at a very high rate of interest.

(iv)Stock Exchanges: The stock exchange facilitate the trading of securities and stocks, and in every trading activity, it charges the brokerage from each party which is its profit.

(v)Mutual Fund Companies: The mutual fund organizations club the amount collected from various investors. These investors have identical investment objectives and risk-taking ability. The funds are then collectively invested in the securities, bonds, and other investment options, to ensure a capital gain in the long run.

(vi)Insurance Companies: These companies provide insurance policies to the individuals and business entities to secure them against accident, death, risk, uncertainties and default. For this purpose, they accept deposits in the form of premium, which is pooled into profitable investments to gain returns. The insured person can claim the money in case of any mishap as per the agreement.

(viii)Financial Advisers or Brokers: The investment brokers also collect the funds from various investors to invest it in the securities, bonds, equities, etc. The financial advisers even provide guidance and expert opinions to the investors.

(ix)Investment Bankers: These banks specialize in services like initial public offerings (IPO), other equity offerings, proving for mergers and acquisitions, institutional client's broker services, underwriting debts, etc. As a result of constant mediation between the investor or public and the companies issuing securities.

(x)Escrow Companies: It is a third party acting as an intermediary and responsible for getting all the conditions fulfilled at the time of loan provided by one party to the other for the real estate mortgage.

(xi)Pension Funds: The government entities initiate a pension fund. A certain amount is deducted from the salary of the employees each month. This collected sum is then invested in different schemes to gain profits. The investor's fund is returned with interest after their retirement.

(xii)Building Societies: These financial intermediaries are similar to the credit unions, owned and facilitating mortgage loans and demand deposits to its members.

(xiii)Collective Investment Schemes: Under this scheme, the various investors with common investment objective come together to pool their funds and collectively invest this amount into a profitable investment option. Later they distribute the interest among themselves as per the agreement.

5. What are the advantages and disadvantages of financial intermediary?

Ans. Advantages of Financial Intermediaries

The financial intermediaries are as crucial to the economy as the blood is to the body. Some of its significant benefits are discussed below

(i)Low Risk: The involvement of intermediaries reduces the risk of fraudulent, default and even capital loss for the lender.

(ii)Convenience: Exchange becomes suitable for the investor as well as the borrower. Since both, the parties do not need to invest time and money in searching for each other. Instead, they have to approach the intermediary for the purpose.

(iii)Economies of Scale: The cost involved in the lending and borrowing of funds like analyzing credit position, operational expenses and cost of paperwork decreases to a large extent. The financial intermediaries perform such activities on a massive scale.

(iv)Financial Specialization: These organizations or companies specialize in fund management and investing activities providing better returns to the investors and easy loans to the borrowers.

(v)Greater Liquidity: The financial intermediaries like banks allow investors or depositors to withdraw their amount at any point of time, as per their requirement.

(vi)Safe Investment: For the investor's point of view, financial intermediaries are considered to be more trustworthy and reliable than lending money directly to an individual to yield interest.

Drawbacks of Financial Intermediaries

Everything has two phases, one is positive, and the other is negative. As we already know that financial intermediaries operate for profits, they are not charitable institutions; the following are some of its disadvantages:

(i)Low Returns on Investment: The ultimate aim of the financial intermediaries is to earn a profit and therefore, they usually provide a low rate of interest on the investment made by the depositors.

(ii) Opposing Goals: The goals of the investors and the financial intermediaries may not complement each other, and therefore the objective of one may not be achieved.

(iii)Fees and Commissions: These intermediaries impose charges, expenses and commission on the financial assistance they provide to their customers.

(iv)False Opportunities: Sometimes, the financial intermediaries come up with the investment opportunities which guarantee high potential returns with the hidden risk involved in it. Even some these, may not yield the promised returns and turn out to be a failure for the investor.

(v)High Interest on Loans: These financial intermediaries charge a high rate of interest on the loan provided to the borrowers to earn a profit.

Financial intermediaries are essential for the growth of a country. They act as the backbone of the economy and facilitate the circulation of money in the market from the individual's households and accounts.

6. Discuss the role of the financial system in the economic development of a country.

Ans. The financial system plays a significant role in the process of economic development of a country. The financial system comprises of a network of commercial banks, Non-banking companies, development banks and other financial and investment institutions offer a variety of financial products and services to suit to the varied requirements of different categories of people. Since they function in a fairly developed capital and money markets, they play a crucial role in spurring economic growth in the following ways:

(i) Mobilising savings: The financial system mobilises the savings of the people by offering appropriate incentives and by deepening and widening the financial structure. In other words, the financial system creates varieties of forms of savings so that savings can take place according to the varying asset preferences of different classes of savers. In the absence of the financial system, all savings would remain idle in the hands of the savers and they would not have flown into productive ventures.

(ii) Promoting investments: For the economic growth of any nation, investment is absolutely essential. This investment has to flow from the financial system. In fact, the level of investment determines the increase in output of goods and services and incomes in the country. The financial system collects the savings and channels them into investment which contributes positively towards economic development.

(iii) Encouraging investment in financial assets: The dynamic role of the financial system in the economic development is that it encourages savings to flow into financial assets (money and monetary assets) as against physical assets (land, gold and other goods and services). The investments in physical assets are speculative and would breed inflation. On the other hand, investment in financial assets are non-inflationary in nature and would aid growth in the economy. The larger the proportion of the financial assets, the greater is the scope for economic growth in the long run.

(iv) Allocating savings on the basis of national priorities: Above all, the financial system allocates the savings in a more efficient manner so that the scarce capital may be more efficiently utilised among the various alternative investments. In other words, it gives preference to certain sectors, from the social and economic point of view, on the basis of national priorities.

(v) Creating credit: Large financial resources are needed for the economic development of a nation. These resources are supplied by the financial system not only in the form of liquid cash but also in the form of 'created money' or 'deposit money' by creating credit and thereby making available large resources to finance trade, production, distribution, etc. Thus, it accelerates economic growth by facilitating the transactions of trade, production and distribution on a large-scale.

(vi) Providing a spectrum of financial assets: The financial system provides a spectrum of financial assets so as to meet the varied requirements and preferences of households. Thus, it enables them to choose their asset portfolios in such a way as to achieve a preferred mix of return, liquidity and risk. Thus, it contributes to the economic development of a country.

(vii) Financing trade, industry and agriculture: All the financial institutions operating in a financial system take all efforts to ensure that no worthwhile project — be it in trade or agriculture or industry — suffers due to lack of funds. Thus, they promote industrial and agricultural development which have a greater say on the economic development of a country.

(viii) Encouraging entrepreneurial talents: The financial institutions encourage the managerial and entrepreneurial talents in the economy by promoting the spirit of enterprise and risk-taking capacity. They also furnish the necessary technical consultancy services to the entrepreneurs so that they may succeed in their innovative ventures.

(ix) Providing financial services: Sophistication and innovations have started appearing in the arena of financial intermediations as well. The financial institutions play a very dynamic role in the economic development of a country not only as a provider of finance, but also as a departmental store of finance by offering varieties of innovative financial products and services to meet the ever increasing demands of their clients both corporate and individuals.

(x) Developing backward areas: The integral policy of the national development plans of every country concentrates on the development of relatively less developed areas called backward areas. The financial institutions provide a package of services, infrastructure and incentives conducive to a healthy growth of industries in such backward areas and thus, they contribute for the uniform development of all regions in a country.

7. Write a detailed note flow of Flow of funds (FOF) Matrix.

Ans. Flow of funds (FOF) is financial accounts that are used to track the net inflows and outflows of money to and from various sectors of a national economy. Macroeconomic data from flow of funds accounts are collected and analyzed by a country's central bank.
The flow of funds accounting system is presented in the form of a matrix by placing sources and uses of funds statements of different sectors side by side. It is an interlocking self-contained system that reveals financial relationships among all sectors of the economy.

For the economy as a whole, total liabilities must equal total financial assets, although for any one sector its liabilities may not equal its financial assets. The consolidated net worth of an economy is consequently identical to the value of its real assets. This implies that saving must equal investment in an economy. Any single sector may save more than it invests or invest more than it saves. But the economy-wise total of saving must equal investment.

Importance:
The flow of funds accounts present a comprehensive and systematic analysis of the financial transactions of the economy. As such, they are useful in a number of ways:

1. The flow of funds accounts is superior to the national income accounts. Even though the latter are fairly comprehensive, yet they do not reveal the financial transactions of the economy which the flow of funds accounts do.

2. They provide a useful framework for studying the behaviour of individual financial institutions of the economy.

3. According of Prof. Goldsmith, they bring “the various financial activities of an economy into explicit statistical relationships with one another and with data on the nonfinancial activities that generate income and production.”

4. They trace the financial flows that interact with and influence the real saving-investment process. They record the various financial transactions underlying saving and investment.

5. They are essential raw materials for any comprehensive analysis of capital market behaviour. They help to identify the role of financial institutions in the generation of income, saving and expenditure, and the influence of economic activity on financial markets.

6. The flow of funds accounts show how the government finances its deficit and surplus budget and acquires financial assets.

7. They also show the results of transactions in government and corporate securities,, net increase in deposits and foreign assets in the economy.

8. The flow of funds accounts help in analysing the impact of monetary policies on the economy as to whether they bring stability or instability or economic fluctuations.

Limitations:

The flow of funds accounts are beset with a number of problems which are discussed as under:

1. The flow of funds accounts are more complicated than the national income accounts because they involve the aggregation of a large number of sectors with their very detailed financial transactions.

2. There is the problem of valuation of assets. Many assets, claims and obligations have no fixed value. It, therefore, becomes difficult to have their correct valuation.

3. The problem of inclusion of non-reproducible real assets arises in the flow of funds accounts. Economists have not been able to decide as to the type of reproducible assets which may be included in flow of funds accounts.

4. Similarly, economists have failed to decide about the inclusion of human wealth in flow of funds accounts.