

The Financial System: An Introduction

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

- 1 Meaning of a financial system
- 2 Components of a financial system
- 3 Functions of a financial system
- 4 Key elements of a well-functioning financial system
- 5 Bank-based and market-based financial systems
- 6 Nature and role of financial institutions and financial markets
- 7 Link between money markets and capital markets
- 8 Link between primary markets and secondary markets
- 9 Functions and characteristics of financial markets

Informal Financial System

Advantages

- Low transaction costs
- Minimum default risk
- Transparency of procedures

Disadvantages

- Wide range of interest rates
- Higher rates of interest
- Unregulated

INTRODUCTION

A financial system plays a vital role in the economic growth of a country. It intermediates between the flow of funds belonging to those who save a part of their income and those who invest in productive assets. It mobilizes and usefully allocates scarce resources of a country.

A financial system is a complex, well-integrated set of sub-systems of financial institutions, markets, instruments, and services which facilitates the transfer and allocation of funds, efficiently and effectively.

Formal and Informal Financial Sectors

The financial systems of most developing countries are characterized by coexistence and cooperation between the formal and informal financial sectors. This coexistence of these two sectors is commonly referred to as 'financial dualism.' The formal financial sector is characterized by the presence of an organized, institutional, and regulated system which caters to the financial needs of the modern spheres of economy; the informal financial sector is an unorganized, non-institutional, and non-regulated system dealing with the traditional and rural spheres of the economy.

The informal financial sector has emerged as a result of the intrinsic dualism of economic and social structures in developing countries, and financial repression which inhibits the certain deprived sections of society from accessing funds. The informal system is characterized by flexibility of operations and interface relationships between the creditor and the debtor. The advantages are: low transaction costs, minimal default risk, and transparency of procedures. Due to these advantages, a wide range and higher rates of interest prevail in the informal sector.

An interpenetration is found between the formal and informal systems in terms of operations, participants, and nature of activities which, in turn, have led to their coexistence. A high priority should be accorded to the development of an efficient formal financial system as it can offer lower intermediation costs and services to a wide base of savers and entrepreneurs.

The Indian Financial System

The Indian financial system can also be broadly classified into the formal (organized) financial system and the informal (unorganized) financial system. The formal financial system comes under the purview of the Ministry of Finance (MoF), the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), and other regulatory bodies. The informal financial system consists of:

- Individual moneylenders such as neighbours, relatives, landlords, traders, and storeowners.
- Groups of persons operating as 'funds' or 'associations.' These groups function under a system of their own rules and use names such as 'fixed fund,' 'association,' and 'saving club.'
- Partnership firms consisting of local brokers, pawnbrokers, and non-bank financial intermediaries such as finance, investment, and chit-fund companies.

In India, the spread of banking in rural areas has helped in enlarging the scope of the formal financial system.

COMPONENTS OF THE FORMAL FINANCIAL SYSTEM

The formal financial system consists of four segments or components. These are: financial institutions, financial markets, financial instruments, and financial services (refer Figure 1.1).

Financial Institutions

These are intermediaries that mobilize savings and facilitate the allocation of funds in an efficient manner. Financial institutions can be classified as banking and non-banking financial institutions. Banking institutions are creators and purveyors of credit while non-banking financial institutions are purveyors of credit. While the liabilities of banks are part of the money supply, this may not be true of non-banking financial institutions. In India, non-banking financial institutions, namely, the developmental financial institutions (DFIs), and non-banking financial companies (NBFCs) as well as housing finance companies (HFCs) are the major institutional purveyors of credit.

Financial institutions can also be classified as term-finance institutions such as the Industrial Development Bank of India (IDBI), the Industrial Credit and Investment Corporation of India (ICICI), the Industrial Financial Corporation of India (IFCI), the Small Industries Development Bank of India (SIDBI), and the Industrial Investment Bank of India (IIBI).

Financial institutions can be specialized finance institutions like the Export Import Bank of India (EXIM), the Tourism Finance Corporation of India (TFCI), ICICI Venture, the Infrastructure Development Finance Company (IDFC), and sectoral financial institutions such as the National Bank for Agricultural and Rural Development (NABARD) and the National Housing Bank (NHB).

Investment institutions in the business of mutual funds Unit Trust of India (UTI), public sector and private sector mutual funds and insurance activity of Life Insurance Corporation (LIC), General Insurance Corporation (GIC) and its subsidiaries are classified as financial institutions.

There are state-level financial institutions such as the State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs) which are owned and managed by the State governments.

In the post-reforms era, the role and nature of activity of these financial institutions have undergone a tremendous change. Banks have now undertaken non-bank activities and financial institutions have taken up banking functions. Most of the financial institutions now resort to financial markets for raising funds.

Financial Markets

Financial markets are a mechanism enabling participants to deal in financial claims. The markets also provide a facility in which their demands and requirements interact to set a price for such claims.

The main organized financial markets in India are the money market and the capital market. The first is a market for short-term securities while the second is a market for long-term securities, *i.e.*, securities having a maturity period of one year or more.

Financial markets can also be classified as primary and secondary markets. While the primary market deals with new issues, the secondary market is meant for trading in outstanding or existing securities. There are two components of the secondary market: over-the-counter (OTC) market and the exchange traded market. The government securities market is an OTC market. In an OTC market, spot trades are negotiated and traded for immediate delivery and payment while in the exchange-traded market, trading takes place over a trading cycle in stock exchanges. Recently, the derivatives market (exchange traded) has come into existence.

Financial Instruments

A financial instrument is a claim against a person or an institution for payment, at a future date, of a sum of money and/or a periodic payment in the form of interest or dividend. The term 'and/or' implies that either of the payments will be sufficient but both of them may be promised. Financial instruments represent paper wealth shares, debentures, like bonds and notes. Many financial instruments are marketable as they are denominated in small amounts and traded in organized markets. This distinct feature of financial instruments has enabled people to hold a portfolio of different financial assets which, in turn, helps in reducing risk.

Classification of Financial Institutions

- Banking and non-banking
- Term finance
- Specialized
- Sectoral
- Investment
- State-level

Types

- Money market
- Capital market

Segments

- Primary market
- Secondary market

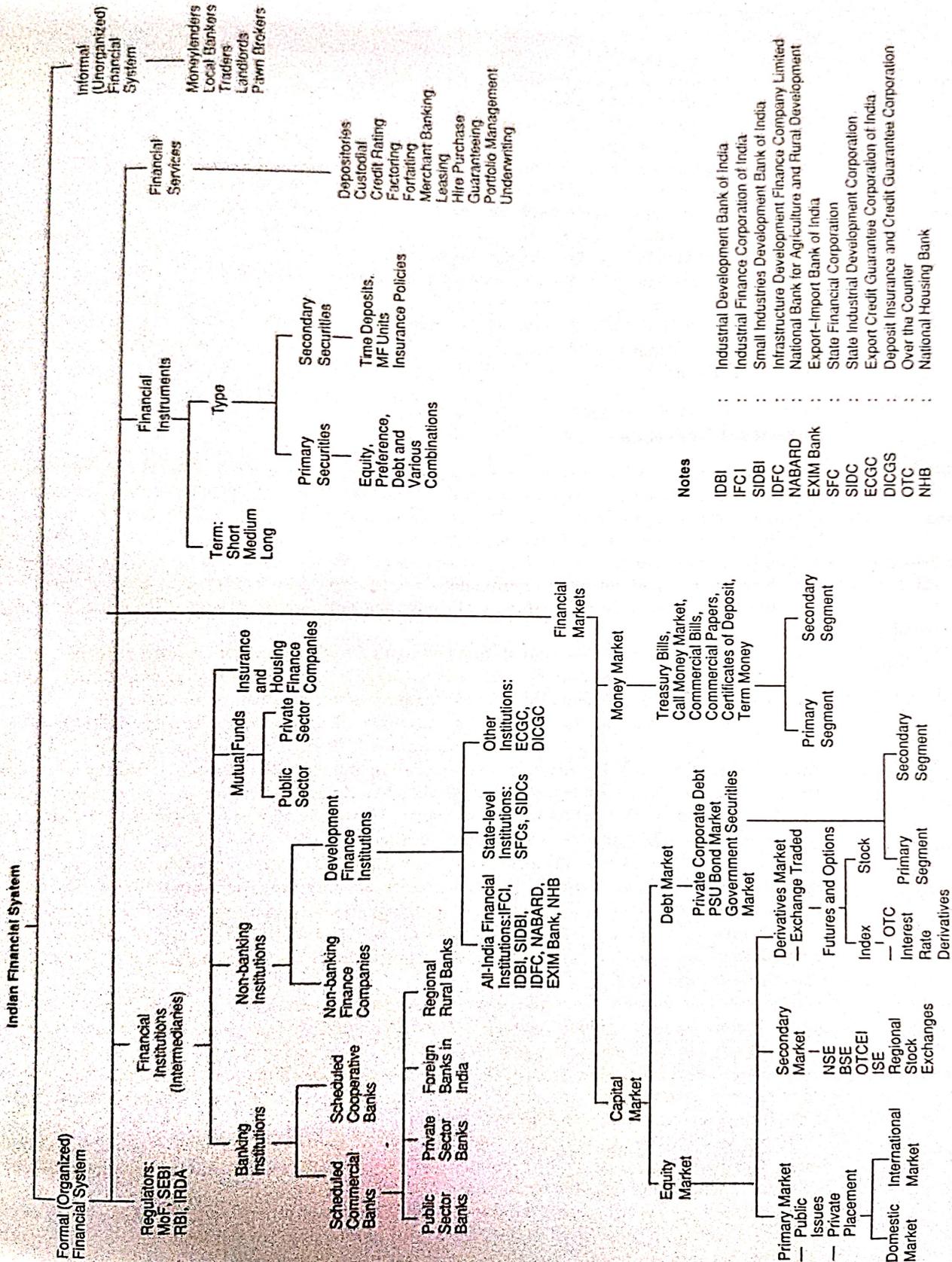


Figure 1.1 Indian Financial System

Types of Financial Securities

- Primary
- Secondary

Distinct Features

- Marketable
- Tradeable
- Tailor-made

Different types of financial instruments can be designed to suit the risk and return preferences of different classes of investors.

Savings and investments are linked through a wide variety of complex financial instruments known as 'securities.' Securities are defined in the Securities Contracts Regulation Act (SCRA), 1956 as including shares, scrips, stocks, bonds, debentures, debenture stocks or other marketable securities of a similar nature or of any incorporated company or body corporate, government securities, derivatives of securities, units of collective investment scheme, security receipts, interest and rights in securities, or any other instruments so declared by the central government.

Financial securities are financial instruments that are negotiable and tradeable. Financial securities may be primary or secondary securities. Primary securities are also termed as direct securities as they are directly issued by the ultimate borrowers of funds to the ultimate savers. Examples of primary or direct securities include equity shares and debentures. Secondary securities are also referred to as indirect securities, as they are issued by the financial intermediaries to the ultimate savers. Bank deposits, mutual fund units, and insurance policies are secondary securities.

Financial instruments differ in terms of marketability, liquidity, reversibility, type of options, return, risk, and transaction costs. Financial instruments help financial markets and financial intermediaries to perform the important role of channelizing funds from lenders to borrowers. Availability of different varieties of financial instruments helps financial intermediaries to improve their own risk management.

Financial Services

These are those that help with borrowing and funding, lending and investing, buying and selling securities, making and enabling payments and settlements, and managing risk exposures in financial markets. The major categories of financial services are funds intermediation, payments mechanism, provision of liquidity, risk management, and financial engineering.

Funds intermediating services link the saver and borrower which, in turn, leads to capital formation. New channels of financial intermediation have come into existence as a result of information technology. Payment services enable quick, safe, and convenient transfer of funds and settlement of transactions.

Liquidity is essential for the smooth functioning of a financial system. Financial liquidity of financial claims is enhanced through trading in securities. Liquidity is provided by brokers who act as dealers by assisting sellers and buyers and also by market makers who provide buy and sell quotes.

Financial services are necessary for the management of risk in the increasingly complex global economy. They enable risk transfer and protection from risk. Risk can be defined as a chance of loss. Risk transfer of services help the financial market participants to move unwanted risks to others who will accept it. The speculators who take on the risk need a trading platform to transfer this risk to other speculators. In addition, market participants need financial insurance to protect themselves from various types of risks such as interest rate fluctuations and exchange rate risk.

Growing competition and advances in communication and technology have forced firms to look for innovative ways for value creation. Financial engineering presents opportunities for value creation. These services refer to the process of designing, developing, and implementing innovative solutions for unique needs in funding, investing, and risk management. Restructuring of assets and/or liabilities, off balance sheet items, development of synthetic securities, and repackaging of financial claims are some examples of financial engineering.

The producers of these financial services are financial intermediaries, such as, banks, insurance companies, mutual funds, and stock exchanges. Financial intermediaries provide key financial services such as merchant banking, leasing, hire purchase, and credit-rating. Financial services rendered by the financial intermediaries bridge the gap between lack of knowledge on the part of investors and the increasing sophistication of financial instruments and markets. These financial services are vital for creation of firms, industrial expansion, and economic growth.

Before investors lend money, they need to be reassured that it is safe to exchange securities for funds. The financial regulator who regulates the conduct of the market and intermediaries to protect the investors' interests provides this reassurance. The regulator regulates the conduct of issuers of securities and the intermediaries to protect the interests of investors in securities and increases their confidence in markets which, in turn, helps in the growth and development of the financial system. Regulation is necessary not only to develop a system, but a system once developed needs to be regulated. The RBI regulates the money market and the SEBI regulates the capital market. The securities market is regulated

Need of Financial Services for

- Borrowing and funding
- Lending and investing
- Buying and selling securities
- Making and enabling
- Payments and settlements
- Managing risk

by the Department of Economic Affairs (DEA), the Department of Company Affairs (DCA), the RBI, and the SEBI. A high-level committee on capital and financial markets coordinates the activities of these agencies.

Interaction Among Financial System Components

The four financial system components discussed do not function in isolation. They are interdependent and interact continuously with each other. Their interaction leads to the development of a smoothly functioning financial system.

Financial institutions or intermediaries mobilize savings by issuing different types of financial instruments which are traded in the financial markets. To facilitate the credit-allocation process, these institutions acquire specialization and render specialized financial services.

Financial intermediaries have close links with the financial markets in the economy. Financial institutions acquire, hold, and trade financial securities which not only help in the credit-allocation process but also make the financial markets larger, more liquid, stable, and diversified. Financial intermediaries rely on financial markets to raise funds whenever the need arises. This increases the competition between financial markets and financial intermediaries for attracting investors and borrowers. The development of new sophisticated markets has led to the development of complex securities and portfolios. The evaluation of these complex securities, portfolios, and strategies requires financial expertise which financial intermediaries provide through financial services.

Financial markets have also made an impact on the functioning of financial intermediaries such as banks and financial institutions. The latter are, today, radically changed entities as the bulk of the service fees and non-interest income that they derive is directly or indirectly linked to financial market-related activities.

Moreover, liquid and broad markets make financial instruments a more attractive avenue for savings, and financial services may encourage further savings if the net returns to investors are raised or increased.

FUNCTIONS OF A FINANCIAL SYSTEM

One of the important functions of a financial system is to link the savers and investors and, thereby, help in mobilizing and allocating the savings efficiently and effectively. By acting as an efficient conduit for allocation of resources, it permits continuous upgradation of technologies for promoting growth on a sustained basis.

A financial system not only helps in selecting projects to be funded but also inspires the operators to monitor the performance of the investment. Financial markets and institutions help to monitor corporate performance and exert corporate control through the threat of hostile takeovers for underperforming firms.

It provides a payment mechanism for the exchange of goods and services and transfers economic resources through time and across geographic regions and industries. Payment and settlement systems play an important role to ensure that funds move safely, quickly, and in a timely manner. An efficient payment and settlement system contributes to the operating and allocation efficiencies of the financial system and thus, overall economic growth. Payment and settlement systems serve an important role in the economy as the main arteries of the financial sector. Banks provide this mechanism by offering a means of payment facility based upon cheques, promissory notes, credit and debit cards. This payment mechanism is now increasingly through electronic means. The clearing and settlements mechanism of the stock markets is done through depositories and clearing corporations.

One of the most important functions of a financial system is to achieve optimum allocation of risk bearing. It limits, pools, and trades the risks involved in mobilizing savings and allocating credit. An efficient financial system aims at containing risk within acceptable limits. It reduces risk by laying down rules governing the operation of the system. Risk reduction is achieved by holding diversified portfolios and screening of borrowers. Market participants gain protection from unexpected losses by buying financial insurance services. Risk is traded in the financial markets through financial instruments such as derivatives. Derivatives are risk shifting devices, they shift risk from those who have it but may not want it to those who are willing to take it.

A financial system also makes available price-related information which is a valuable assistance to those who need to take economic and financial decisions. Financial markets disseminate information for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment,

Interaction Among the Components

- Interdependent
- Interactive
- Close links
- Competing with each other

Functions of a Financial System

- Mobilize and allocate savings
- Monitor corporate performance
- Provide payment and settlement systems
- Optimum allocation of risk-bearing and reduction
- Disseminate price-related information
- Offer portfolio adjustment facility
- Lower the cost of transactions
- Promote the process of financial deepening and broadening

or holding a particular asset. This information dissemination enables a quick valuation of financial assets. Moreover, by influencing the market price of a firm's debt and equity instruments, this process of valuation guides the management as to whether their actions are consistent with the objective of shareholder wealth maximization. In addition, a financial system also minimises situations where the information is asymmetric and likely to affect motivations among operators when one party has the information and the other party does not. It also reduces the cost of gathering and analysing information to assist operators in taking decisions carefully.

A financial system also offers portfolio adjustment facilities. These are provided by financial markets and financial intermediaries such as banks and mutual funds. Portfolio adjustment facilities include services of providing a quick, cheap and reliable way of buying and selling a wide variety of financial assets.

A financial system helps in the creation of a financial structure that lowers the cost of transactions. This has a beneficial influence on the rate of return to savers. It also reduces the cost of borrowing. Thus, the system generates an impulse among the people to save more.

A well-functioning financial system helps in promoting the process of financial deepening and broadening. Financial deepening refers to an increase of financial assets as a percentage of the Gross Domestic Product (GDP). Financial depth is an important measure of financial system development as it measures the size of the financial intermediary sector. Depth equals the liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and non-bank financial intermediaries divided by the GDP). Financial broadening refers to building an increasing number and variety of participants and instruments.

KEY ELEMENTS OF A WELL-FUNCTIONING FINANCIAL SYSTEM

The basic elements of a well-functioning financial system are (i) a strong legal and regulatory environment, (ii) stable money, (iii) sound public finances and public debt management, (iv) a central bank, (v) a sound banking system, (vi) an information system, and (vii) a well-functioning securities market.

Since finance is based on contracts, strong legal and regulatory systems that produce and strictly enforce laws alone can protect the rights and interests of investors. Hence, a strong legal system is the most fundamental element of a sound financial system.

Stable money is an important constituent as it serves as a medium of exchange, a store of value (a reserve of future purchasing power), and a standard of value (unit of account) for all the goods and services we might wish to trade in. Large fluctuations and depreciation in the value of money lead to financial crises and impede the growth of the economy.

Sound public finance includes setting and controlling public expenditure priorities and raising revenues adequate to fund them efficiently. Historically, these financing needs of the governments world over led to the creation of financial systems. Developed countries have sound public finances and public debt management practices, which result in the development of a good financial system.

A central bank supervises and regulates the operations of the banking system. It acts as a banker to the banks, banker to the government, manager of public debt and foreign exchange, and lender of the last resort. The monetary policy of the central bank influences the pace of economic growth. An autonomous central bank paves the way for the development of a sound financial system.

A good financial system must also have a variety of banks both with domestic and international operations together with an ability to withstand adverse shocks without failing. Banks are the core financial intermediaries in all countries. They perform diverse key functions such as operating the clearing and payments system, and the foreign exchange market. The banking system is the main fulcrum for transmitting the monetary policy actions. Banks also undertake credit risk analysis, assessing the expected risk and return on the projects. The financial soundness of the banking system depends on how effectively banks perform these diverse functions.

Another foundational element is information. All the participants in a financial system require information. A sound financial system can develop only when proper disclosure practices and networking of information systems are adopted.

Securities markets facilitate the issue and trading of securities, both equity and debt. Efficient securities markets promote economic growth by mobilizing and deploying funds into productive uses, lowering the cost of capital for firms, enhancing liquidity, and attracting foreign investment. An efficient securities market strengthens market discipline by exerting corporate control through the threat of hostile takeovers for underperforming firms.

Basic Elements of a Well-functioning Financial System

- A strong legal and regulatory environment
- Stable money
- Sound public finances and public debt management
- A central bank
- Sound banking system
- Information system
- Well-functioning securities market