Introduction:

Finance is like an important vitamin that everyone needs for the survival and growth. It is required not only for an individual but also for the business enterprises, government, government agencies, non-government organizations etc. Finance shows how the business entities use their financial resources on a certain period of time under good or bad conditions. It focuses on how the money is budgeted and spent.

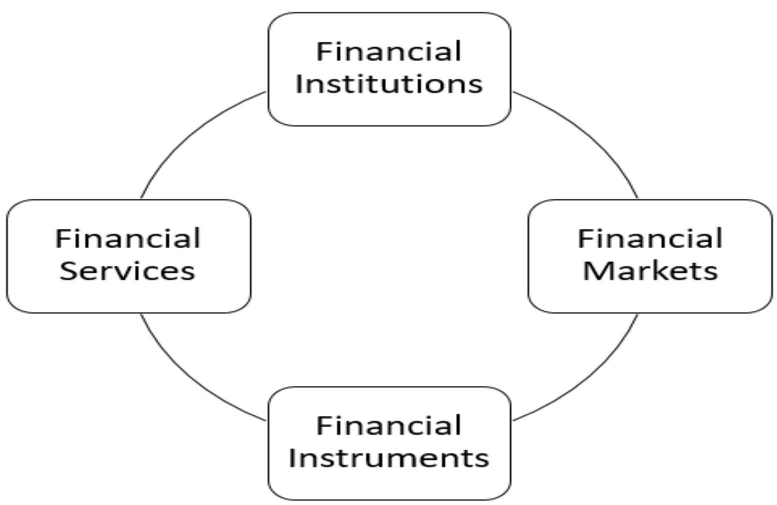
Meaning of Financial System:

The term financial system is a set of interrelated activities or services to achieve some pre-determined goal. It includes financial markets, institutions, instruments and services.

Definition of Financial System:

Prof. S.B. Gupta defines the financial system as “A set of institutional arrangements through which financial surpluses available in the economy are mobilized”.

Interconnected activities of financial system:



Financial Institutions: These are backbone of financial system. They mobilize and transfer the savings from the surplus units either directly or indirectly. Financial institutions consist of Regulatory bodies, Intermediaries, Non-intermediaries and others.

Financial Instruments: The commodities that are traded in a financial market is known as financial instruments. Financial assets represent a claim on the repayment of principal &

additional income (interest/dividend) at a future date. Shares, Debentures, Bonds are some examples of financial instruments.

Financial Services: It refers to various services offered by financial institutions. The financial services help not only to raise the required funds but also ensure their efficient use. Some of the examples of these services are banking, insurance, factoring etc.

Financial Markets: Financial market is a place for the purchase and sale of various financial assets. Markets creates a platform for many interested buyers and sellers including households, firms and government agencies.

Features of Financial System:

The following are the features of financial system:

- ✓ It is a set of inter-related activities.
- ✓ Services are working together to achieve pre-determined objectives.
- ✓ The system allows transfer of money between the savers & borrowers.
- ✓ It is applicable at global, national, & firm level.
- ✓ It includes financial institutions, markets, instruments services, practices & transactions.
- ✓ The main objective is to formulate capital, investment & profit generation.

Objectives of Financial System:

The financial system performs the following functions:

- ✓ **To stimulate capital formation:**

  The objective of supporting the industries is not ended with the sanctioning of funds to them. Further, it makes them to formulate the capital out of their earnings for the further capital requirements & industrial investment.
- ✓ **To accelerate the process of economic growth:**

  The ultimate goal of the financial institutions is to support the process of economic growth of a nation. Directing the saving fund to the industrial capital need, motivating them for the capital formation support the acceleration of the process of economic growth.
- ✓ **To mobilize the financial resources:**

The first & the foremost function which financial system performs is the channelization of the individual's savings & making it available for borrowers. The borrowers are usually the companies which take loan in order to increase the overall growth of the economy. It collects the funds through offering different schemes which attract the investors to fund their savings in different institutions, services, securities etc.

- ✓ **It ensures effective allocation of resources:**

  It also creates an environment for one to invest their funds which involves good returns on investment. It provides various opportunities to secure the investment against risks involved in the market like risk arising from accidents, health related etc..through various life insurance options. It helps in liquidating one's own savings whenever required

Functions of Financial System:

The following are the functions performed by the financial system of a nation.

- ✓ **Provision of Liquidity:**

  It states the ability of meeting the obligations as & when they are required. In other parameter, it states the ability of converting the assets into liquid cash without any loss.

- ✓ **Mobilization of savings:**

  It is the function of financial institutions, a subdivision of financial system, to mobilize the savings from the saver or investor group. It requires proper & attractive scheme through which public savings could be mobilized.

- ✓ **Small savings to big investment:**

  Financial system acts as an intermediary in transforming the mobilized fund of saving to the big investment. It offers different credit schemes to the fund needy people to get fund from financial institutions for the investment objective.

- ✓ **Maturity transformation function:**

  The financial system receives the saving fund from the depositors for a particular tenure (FD) & lend the same fund to the required people on the term basis. Here maturity of transformation stands for the period of deposit from the public & lending the same for a definite period as loan or cash credit.

- ✓ **Risk transformation function:**

  The small savers are usually risk averse (one who avoids risk). Who do not want to invest their small saving fund in the risk ventures. Hence the financial institutions take the responsibility of transforming their risk in investing their fund in profitable & safe venture by bearing the risk.

Classification/ Structure of Financial System:

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Financial Markets:
It refers to the institutional arrangement for buying and selling financial assets, including capital & credit.Financial market consists of money markets & the capital markets.

According to **Brigham, Eugene F**, **"the place where people & organizations wanting to borrow money are brought together with those having surplus funds is called a financial Market".**

Functions of financial markets:

- ✓ To facilitate creation & allocation of credit & liquidity.
- ✓ To serve as intermediaries for mobilization of savings.
- ✓ To assist the process of balanced economic growth.
- ✓ To provide financial convenience.
- ✓ To cater the various credit needs of the business houses.

Types of Financial Markets:

Unorganized Financial Market: these are comprised with private money lenders, pawn brokers, indigenous bankers, traders etc. they lend money to the public from their own fund.

Organized Financial Market: these are the markets strictly controlled & regulated by RBI & other regulating authorities. They follow high degree of institutionalization. It includes Capital Market and Money Market .

A. Capital Market

The term 'Capital Market' refers to an institutional arrangements for facilitating the borrowing & lending of long-term funds. Capital Market is a market for financial assets which have a long or indefinite maturity. The capital market instruments become mature for the period above one year. It is also called as long term securities market.

In the widest sense, it consists of a series of channels through which the savings of the community are made available for industrial & commercial enterprises & public authorities. Capital market consists Instruments such as Shares,debentures,longterm bonds etc.

Objectives & Importance:

- ✓ Ensures best possible coordination & balance between the flow of savings on the one hand & the flow of investment leading to capital formation on the other.

- ✓ Directs the flow of savings into most profitable channels & thereby ensures optimum utilization of financial resources.
- ✓ The mobilization or concentration of national savings for the economic development.
- ✓ To maintain the expected rate of economic growth.

Features:

- ✓ Mobilization of savings & acceleration of capital formation.
- ✓ Promotion of industrial growth.
- ✓ Raising long term capital.
- ✓ Proper channelization of funds.

Capital Market in India

Government Securities (Gilt-edged market)	**Industrial Securities Market**		**Development financial institutions**	**Financial Intermediaries**		
	New Issue Market	**Old Issue market (Stock Market)**	**IFCI ICICI IDBI UTI**	**Merchant Banks**	**Mutual Funds**	**Leasing etc**

Government Securities Market:
These are the markets where securities are traded. Securities issued by the central government, semi-government authorities. The government securities does not carry any risk so they are termed as **risk free gilt edged securities/ instruments.**
In India, government issues both treasury bills & bonds or dated securities while the state government issues only bonds or dated securities, which are called the **state development loans.**

The following are the types of government securities in India:
Treasury Bills: these are money market & short term debt instruments issued by the government of India & are presently issued in 3 tenors, Viz, 91 days, 182 days& 364 days.
Cash management Bills: these are the new short term instruments issued by government of India, in consultation with RBI, to meet the temporary mismatches in the cash flow of the management.
Dated government securities: these are the long term securities & carry a fixed or floating rate of interest paid on the face value, payable at fixed time period (usually half yearly). The tenor of dated securities can be up to 30 years.
State development loans: these are dated securities issued through an auction similar to the auctions conducted for dated securities issued by the central government.

Industrial Securities Market:

The market for industrial securities is known as industrial securities market. It is an ideal market for corporate securities such as bonds & equities.

Primary Market

It is also called as **new issue market.** In this market the securities are purchased directly from the issuer. Both the new companies & existing companies can raise capital on the new issue market.

Primary Market Instruments:

Classification of corporate securities

Ownership securities			**Creditorship Securities**
Ordinary or Equities	**Preference Shares**	**Defferred shares**	**Debentures**

Ownership securities:

The term ownership securities also known as 'Capital stock' represents Shares.
Equity Shares: They are also called ordinary shares or common shares represents the owner capital in a company. The holder of these shares are the real owners of the company. They have a control over the working of the company. Equity share holders are paid dividend after paying it to the preference share holders.

Preference shares: As name itself suggests, these shares have preference as compared to other types of shares. These shares are given two preference. The preference for payment of dividend & preference for these shares for repayment of amount in the liquidation of the company.
No par stock or shares: it means shares having no face value. The capital of a company issuing such shares are divided into a number of specified shares without any denomination. The share certificate of the company simply states the number of shares held by its owner without mentioning any face value.
Shares with differential rights: Shares with differential rights means shares issued with differential rights in accordance with section 86 of the Companies Act eg: with voting rights without voting rights.
Sweat Equity: it means shares issued by accompany to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual rights or value additions, by whatever name called. The idea behind the issue of sweet equity is that an employee or director works best when has sense of belongingness & is amply rewarded.

Creditorship Securities: it is also known as debt capital represents debentures & bonds. They occupy a very significant place in the financial plan of the company.
Debentures/ Bonds: A Company may raise long term funds through public borrowings. These loans are raised by the issue of debentures. A debenture is an acknowledgement of a company. It is a certificate issued by a company under its seal acknowledging a debt due by to its holders.

A company may raise capital in primary market out of the following three routes from the public.
Initial Public Offer: Raising the fund by issuing the securities to the general public for the First time.
Rights issue: these are the securities issued to the existing shareholders as a statutory right to meet working capital requirements.
Private placement: these are the securities offered to the private individuals/ group or recognized institutions. These are not available to the general public to invest in.

Intermediaries/Players in the Primary Market
Merchant Bankers: They carry out the work of Underwriting of Shares, Portfolio management, Issue Management etc. they are required to get separate registration with

SEBI as portfolio managers. underwriting can be done without any additional registration. Only body corporate with net worth of 5 crores are allowed to work as merchant bankers.
Underwriters: The issuing company has to appoint underwriters in consultation with the merchant bankers or lead managers. The underwriters play an important role in the development of the primary market. The underwriters are the institutions or agencies, which provide a commitment to take up the issue of securities in case the company fails to get subscription from the public.
Bankers to the issue: The bankers play an important role in the working of the primary market. They collect applications for shares & debentures along with application money from investors in respect of issue of securities & also refund of the application money to whom shares are not allotted
Registrars & shares transfer agents: Registrar is an intermediary which carries out function such as keeping a proper record of application & money received from investors, assisting the companies in determining the basis of allotment of securities as per stock exchange guidelines & in consultation with stock exchange assistance.
Share transfer agents are also intermediaries who carry out functions of maintaining records of holders of securities of the company for & on behalf of the company & handling all matters related to transfer & redemption of securities of the company.

Secondary Market

Stock market represents the secondary market where existing securities are traded, stock exchange provides an organized mechanism for purchase and sale of existing securities. At present there are 24 approved stock exchanges in our country.
Securities Contract (regulation) act, 1956. "Stock exchange means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling in securities".

Features:

- ✓ **Accurate information:** Secondary market should provide an efficient, accurate & adequate information to the investors, industries & general public. There should not be any delay in providing trading information.
- ✓ **Liquidity:** An efficient secondary market should also provide the adequate liquidity for trading. This will happen when adequate number of buyers & sellers are present in the market.
- ✓ **Transactions:** in respect of transactions, there must be efficient & market should provide low transaction cost to attract more number of investors.

- **Share Price:** All the new information & facts should be reflected in the share price of a company or group of company within the minimum possible time.

Functions:

- **Ensure liquidity of capital:**
  The Stock exchange provide a place for where shares & stocks are converted into cash. The exchanges provide a ready market where buyers & sellers are always available & those who are in need of hard cash can sell their holdings.
- **Continuous market for securities:**
  The stock exchanges provide a ready market for securities. The securities one listed continue to be traded at the exchange irrespective of the fact that owners go on changing.
- **Evaluation of surplus:**
  The investors can evaluate the worth of their holdings from the prices quoted at different exchanges for those securities. The securities are quoted under the free atmosphere of demand & supply & the prices are set on the basis of free market.
- **Mobilizing Surplus savings:**
  The stock exchanges provide a ready market for various securities. The investors do not have any difficulty in investing their savings by purchasing shares, bonds etc from the exchanges.
- **Helpful in raising new capital:**
  The new & existing concerns need capital for their activities. The new concerns raise capital for the first time & existing units increase their capital for expansion & diversification purpose. The shares of new concerns are registered at stock exchanges & existing companies also sell their shares through brokers etc.
- **Safety in dealings:**
  the dealings at stock exchange are governed by well-defined rules & regulations of securities Contract (Regulation) Act, 1956. There is no scope for manipulating transactions. Every contact is done according to the procedure laid down & there is no fear in the minds of contracting parties.
- **Listing of securities:**
  Only listed securities can be purchased at stock exchange. Every company desirous of listing its securities will apply to the exchange authorities. The listing is allowed only after a critical examination of capital structure.
- **Platform for public debt:**

The increasing government's role in economic development had necessitated the raising of huge amounts for this purpose. The stock exchange provides a platform for raising public debts.

- ✓ **Clearing House of business information:**
  The companies listing securities with exchanges have to provide financial statements, annual reports & other reports to ensure maximum publicity of corporation operations & working.
- ✓ **Serves as economic barometer:**
  Market indicates the state of health of companies & the national economy. It acts as a barometer of the economic situation.
- ✓ **Facilitates bank lending:**
  Banks easily know the prices of quoted securities. They offer loans to customers against corporate securities holding by them. This gives convenience to the owners of securities to transact more.

Difference between Primary & Secondary Market

Primary market	**Secondary market**
It Is also called as new issue market or IPO market	**It is called as stock market or after market**
It is the main market to which stocks will be issued by the company	**It is an additional market to which the stocks are selling**
This market is not depending on any other market	**It depends on primary market**
The purpose of the market is to raise the fund for a company by issuing fresh securities	**It is for investors benefit to trade**
It is for capital investment	**It is for speculation**

Development financial institutions:

These are the group of all India financial institutions. These play a pivotal role in the financial markets & assist in the proper allocation of resources, sourcing from business that have a surplus & distributing to others who have deficits, ensure continued circulation of money in the country.

Eg: IDBI, IFCI, EXIM bank etc.

Money Market:

It is a market for short term financial assets that are close substitute for money. The money market is a mechanism that deals with the lending & borrowing of short term funds for less than one year.

In money market financial instruments with high liquidity & very short maturities are traded. The transactions have to be carried out without the help of brokers.

Meaning and Definition:

Money market refers to the institutional arrangement facilitating borrowing & lending of short term funds. The Money market brings together the lenders who have surplus short term investible funds & the borrowers who are in need of short term funds.

According to C Growther, "Money market is the collective name given to the various firms and institutions that deal in the various grades of near money".

Objectives of Money Market:

- To provide room for overcoming short term deficits.
- To provide parking places to employ short term surplus funds.
- To enable the central bank to influence & regulate liquidity in the economy through its intervention.
- To provide a reasonable access to users of short term funds to meet their requirements quickly, adequately & at reasonable costs.

Components of Money Market:

- **Call Money Market:**

It refers to the market for extremely short period loans. Bill brokers and dealers in the stock exchange borrow for a very short period of one day/overnight and maximum of seven days.

These brokers borrow money from commercial banks, such short period loans are called 'call loans' as these can be recalled by the lending bank at any time. There is no collateral security demanded against these loans. Call money markets are located in big commercial centres like Mumbai, Kolkata, Chennai, Delhi etc.

- **Collateral Loan market:**

  This is market which deals with collateral loans that is loans backed up by collateral securities like stocks & bonds etc. is known as collateral loan market.

  These loans are given for short period, generally lasting a few months. The borrowers are dealers, brokers, small banks etc. The collateral security is returned by the lender on the repayment loan but if the loan is not repaid the security may be retained by the lender.

- **Bill market or Discount market:**

  It refers to the market in which short period papers or bills are bought & sold. The most important paper is commercial bill. There are two types of commercial bills- Bill of exchange & Treasury bill.

- **Acceptance Market:**

  It refers to the market for Banker's acceptance involved in trade transactions. It is a draft drawn by an individual or a firm upon a bank & accepted by it to pay to the order of a specified person or to the bearer, a certain sum of money on a specified date in future.

Functions of money market:

1) It caters to the short-term financial needs of the economy.

2) It helps the RBI in effective implementation of monetary policy.

3) It provides mechanism to achieve equilibrium between demand and supply of short-term funds.

4) It helps in allocation of short term funds through inter-bank transactions and money market Instruments.

5) It also provides funds in non-inflationary way to the government to meet its deficits.

6) It facilitates economic development.

7) The money market constitutes a highly efficient mechanism for credit control.

Money market instruments:

1) **Commercial Papers:** It is a short term unsecured loan issued by a corporation typically financing day to day operation. These are not usually backed by any form of collaterals and is allowed to be issued only by corporate with high quality debt ratings. The debt is usually issued at a discount, reflecting prevailing market interest rates. Commercial Paper were introduced in India in 1990 with a view to enable high rated corporate borrowers to raise short term borrowers.. A major benefit of commercial paper is that it does not need to be registered with the Securities and Exchange Commission (SEC) as long as it matures before nine months (270 days), making it a very cost-effective means of financing.
    - CP can be issued in denominations of Rs.5 lakh or multiples thereof.
    - CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue.
    - CPs are normally issued by the banks, public utilities, insurance & finance companies.
    - The issuing company must have tangible net worth of Rs.4 crore.
    - The minimum size of an issue to a single investor is to be rs.25lakh.
    - The issuing company should have minimum credit rating of A3 from any Credit rating agency.

2) Treasury Bill (T - Bills) :

This is a short term government security issued by RBI on behalf of government of India usually of the duration 91 days, 182 days & 364days treasury bills. Treasury bills are purchased for a price that is less than their face value when they mature, the government pays the holder the full face value.

Periodic auctions are held for their Issue, these are sold by the RBI on the basis of competitive bidding. Interest rate is determined by market forces. Commercial Banks, Primary Dealers, Mutual Funds, Corporates, Financial Institutions, Provident or Pension Funds and Insurance Companies can participate in T-bills market.

Types of TBs:

Regular/Ordinary TBs are issued to public by the RBI through the process of auction or bidding.

Adhoc-TBs are issued in favour of RBI with a view to replenish government's finance.

- Treasury bills are available for a minimum amount of Rs.25,000 and in multiples of Rs.25,000.
- Maturity period is 14 days to 364 days.
- There is absence of risk in TBs.
  It has no tax deducted at source.
- T-bills are highly liquid, readily available.
- State government does not issue any treasury bills.

3) Commercial Bills:

Commercial bills are short term, negotiable and self-liquidating money market instruments with low risk. A bill of exchange is drawn by a seller on the buyer to make payment within a certain period of time. Generally, the maturity period is of three months. Commercial bill can be resold a number of times during the usance period of bill. The commercial bills are purchased and discounted by commercial banks and are rediscounted by financial institutions like EXIM banks, SIDBI, IDBI etc.

4) Certificate Of Deposits (CDs) :

Certificate of Deposit (CD) is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note against funds deposited at a bank or other eligible financial institution for a specified time period.

CDs are issued by Commercial banks and development financial institutions. The scheme of CDs was introduced in 1989 by RBI. The main purpose was to enable the commercial banks to raise funds from market. CDs can be issued at discount to face value. They are freely transferable but only after the lock-in-period of 45 days after the date of issue. In 1992, RBI allowed four financial institutions ICICI, IDBI, IFCI and IRBI to issue CDs with a maturity period of one year to three years.

- At present, the maturity period of CDs ranges from 3 months to 1 year.
- Minimum amount of a CD should be Rs.1 lakh, i.e., the minimum deposit that could be accepted from a single subscriber should not be less than Rs.1 lakh, and in multiples of Rs.1 lakh thereafter.(2012 RBI guidelines)
- According to 1997-98 guidelines of RBI Minimum denomination of CD is Rs.5lakh.CDs are issued in multiples of Rs.25 lakh subject to a minimum size of Rs.1 crore.

5) Repurchase Agreement (REPO):

Repo is a form of overnight borrowing & is used by those who deal in govt. securities. They are usually very short term instruments from overnight to 30 days or more. Repo was introduced in December 1992. Repurchase agreement means selling a security under an agreement to repurchase it at a predetermined date and rate. It enables collateralised short term borrowing & lending thorough sale/purchase operations in debt instruments. Repo transactions are affected between banks and financial institutions and among bank themselves.

6) Banker's Acceptance:

It is a short term credit investment created by a non-financial firm. Acceptance are traded at discounts from face value in the secondary market. Acceptance is guaranteed by a bank to make payment. Banker's acceptance acts as a negotiable time draft for financing imports & exports.

Limitations of money market:

1. **Dichotomy:-**

A major feature of Indian Money Market is the existence of dichotomy i.e. existence of two markets: -Organised Money Market and Unorganised Money Market. Organised Sector consist of RBI, Commercial Banks, Financial Institutions etc. The Unorganised Sector consist of IBs, MLs, Chit Funds, Nidhis etc. It is difficult for RBI to integrate the Organised and Unorganised Money Markets. Several segments are loosely connected with each other. Thus there is dichotomy in Indian Money Market.

2. **Lack of Co-ordination and Integration:-**

It is difficult for RBI to integrate the organised and unorganised sector of money market. RBT is fully effective in organised sector but unorganised market is out of RBI's control. Thus there is lack of integration between various sub-markets as well as various institutions and agencies. There is less co-ordination between co-operative and commercial banks as well as State and Foreign banks. The indigenous bankers have their own ways of doing business.

3. **Diversity in Interest Rates:-**

There are different rates of interest existing in different segments of money market. In rural unorganised sectors the rate of interest are high and they differ with the purpose and borrower. There are differences in the interest rates within the organised sector also. Although wide differences have been narrowed down, yet the existing differences do hamper the efficiency of money market.

4. Seasonality of Money Market :-

Indian agriculture is busy during the period November to June resulting in heavy demand for funds. During this period money market suffers from Monetary Shortage resulting in high rate of interest. During slack season rate of interest falls & there are plenty of funds available. RBI has taken steps to reduce the seasonal fluctuations, but still the variations exist.

5. Shortage of Funds :-

In Indian Money Market demand for funds exceeds the supply. There is shortage of funds in Indian Money Market an account of various factors like inadequate banking facilities, low savings, lack of banking habits, existence of parallel economy etc. There is also vast amount of black money in the country which have caused shortage of funds. However, in recent years development of banking has improved the mobilisation of funds to some extent.

6. Absence of Organised Bill Market :-

A bill market refers to a mechanism where bills of exchange are purchased and discounted by banks in India. A bill market provides short term funds to businessmen. The bill market in India is not popular due to overdependence of cash transactions, high discounting rates, problem of dishonour of bills etc.

7. Inadequate Banking facilities :-

Though the commercial banks, have been opened on a large scale, yet banking facilities are inadequate in our country. The rural areas are not covered due to poverty.

Their savings are very small and mobilisation of small savings is difficult. The involvement of banking system in different scams and the failure of RBI to prevent these abuses of banking system shows that Indian banking system is not yet a well organised sector.

8. Inefficient and Corrupt Management :-

One of the major problem of Indian Money Market is its inefficient and corrupt management. Inefficiency is due to faulty selection, lack of training, poor performance appraisal, faulty promotions etc. For the growth and success of money market, there is need for well trained and dedicated workforce in banks. However, in India some of the bank officials are inefficient and corrupt.

The above defects of Indian Money Market clearly indicate that it is relatively less developed and has yet to acquire sufficient depth and width. The deficiencies are slowly and steadily overcome by policy measures undertaken by RBI from time to time.

Financial Intermediaries:

Financial intermediary is an financial institution that connects surplus & deficit agents.

(a) **Merchant Banking:** it is a financial institution primarily engaged in offering financial services & advice to corporations & wealthy individuals on how to use their money.
(b) **Mutual funds:** it is a type of professionally managed collective investment vehicle that pools money from investors to purchase securities.
(c) **Venture capital:** it is a financial capital provided to early stage, high potential, high risk, growth startup companies. Some of the financial intermediaries are established to offer venture capital to novel technology or business model.
(d) **Leasing:** it is the process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductable payments.
(e) **Factoring:** the financial institutions are handling some factoring job to reduce risk of their customers in collecting & setting the transactional dues.