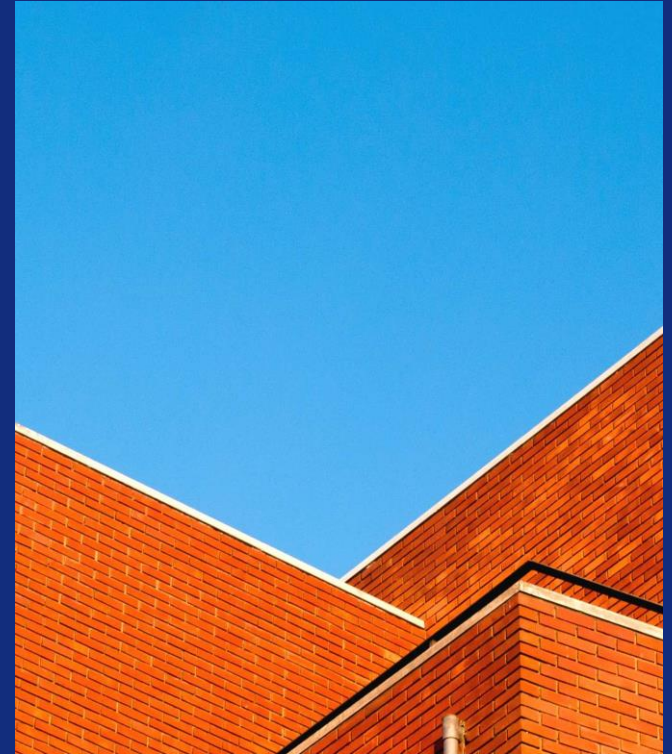


# Financial System

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## HIGHLIGHTS

- Introduction
- Meaning
- Nature
- Constituents/Components
- Function
- Key elements
- Organization

# Introduction

A financial system plays a vital role in the economic growth efficiently and effectively.

It intermediates between the flow of funds belonging to those who save a part of their income and those who invest in productive assets.

Financial System is a complex, well-integrated set of sub-systems of

- Financial institution,
- Markets,
- Instruments, and
- Services
- which facilitates the transfer and allocation of funds

## Formal and Informal Financial system economy

- Formal Financial Sector is characterized by presence of an organized, institutional and regulated system which caters the financial needs of the modern spheres of the economy.
- Informal Financial Sector is an unorganized, non-institutional and non-regularized system dealing with the traditional and rural spheres of the economy
- Financial Dualism: It is the combination of formal and informal financial system.

## Informal Financial System

Informal Financial Sector is an unorganized, non-institutional and non-regularized system dealing with the traditional and rural spheres of the economy.

Advantages: 1). Minimum default risk, 3). Less of formalities, 4). Less time consuming, 5). Fulfillment of urgent requirements.

Disadvantages: 1). Unregulated 2). High rates of interest 3). Less transparency of procedures, 4). Rise to black money, 5). Exploitation of victims.

- 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), Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI) and other regulatory bodies.

# Indian Financial System

# Nature of Financial System

- Transfer Funds
- Mobilizes Saving
- Risk Allocation
- Facilitates Investment
- Enhances Liquidity

# Components of Formal Financial System<sup>1</sup>

1. Financial institutions;

2. Financial markets;

3. Financial instruments;

4. Financial services.



## 1 Financial institutions

These are intermediaries that mobilize savings and facilitate the allocation of funds in an efficient manner.

### Classification of Financial Institutions

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

## 1. Financial institutions

- Term finance institutions: IFCI (1948), IDBI (1964), ICICI (1955), SIDBI (1989), IIBI (1997).
- Specialized services institutions: EXIM (1982), TFCI (1994), ICICI VENTURE;
- Sectoral financial institutions: NABARD (1982), NHB (1988).
- Investment institutions: UTI (1964), LIC (1955), GIC (1972) and its subsidiaries;
- state-level financial institutions: SIDC (1955), SFC (1951).

## 2 Financial Market

- Financial markets are a mechanism enabling participants to deal in financial claims.
- The main organized financial markets in India are the money market and the capital market.
- Financial markets can also be classified as primary and secondary markets.
- There are two components of the secondary market: over-the-counter (OTC) market and the exchange traded market.

## Type of Financial Market

- Financial markets can also be classified as primary and secondary markets.
- There are two components of the secondary market: over-the-counter (OTC) market and the exchange traded market.
- Capital market: A market for long-term securities or securities with a maturity period of one or more year.

## Type of CapitalMarket

1. Primary market: It refers to the market:
  - Where securities are created/issued;
  - where the securities are traded for very first time;
2. Secondary market: it refers to the market where those securities traded which have already been issued in the primary market:
  - Over the counter:
  - Trade through stock exchanges

## Type of CapitalMarket

1. Over the counter:
  - It refers to the process of how securities are traded for companies that not listed on a formal exchange
  - Stocks that trade via OTC are typically smaller companies that cannot meet exchange listing requirements
  - OTC securities trade by broker-dealers who negotiate directly with one another over computer networks and by phone using the OTC
2. Trade through stock exchanges:  
Approach to BSE, NSE or any other stock exchange through stock brokers or agents of registered broking companies.

### 3. 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.
- 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.

### 3 Financial Instruments

- Types of Financial Securities

  - Primary

  - Secondary

- Distinct Features

  - Marketable

  - Tradeable

  - Tailor made



## 4 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.

## 4. Financial Services

### Need of Financial Services for

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

## Interaction Among Financial System Components

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

## FUNCTIONS OF A FINANCIAL SYSTEM

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- 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

# Keys elements of well functioning financial system<sup>1</sup>

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