SEM-III _ B.Com (Hons)_ INDIAN FINANCIAL SYSTEM_ UNIT 1

FINANCIAL SYSTEM AND ITS COMPONENTS

DEFINITION OF MONEY

According to Prof. Crowther," Money can be defined as anything that is generally acceptable as a means of exchange (i.e. as a means of setting debts) at the same time acts as a measure and as a store of values."

According to Sayers, "Money is something that is widely accepted for the the settlement of the debts."

In general it can be said that, a material which is acceptable to all as a medium of of exchange and work as unit of measure of value, standard of deferred payment and store of value of a country in a fixed era is called money in economics.

FUNCTIONS OF MONEY

The four main functions of money are

1.Medium of exchange

2.Unit of measure of value

3.Standard of deferred payment

4.Store of value

Four main functions of money are discussed below:

1. Medium of exchange:

The main function of money is to make transaction system easy and simple by removing the main problem of inconsistency of demand in barter system of exchange.

2. Unit of measure of value:

Exchange rate of every commodity in terms of money and price of every commodity in terms of money are possible to express due to use of money e as a medium of exchange. For example if the price of 1kg rice is 30/- and the price of 1 kg wheat is 15/- then the value of 1 kg rice = the value of 2 kg of wheat.

3. Standard of deferred payment:

Actually credit is accepted on the basis of future payment i.e. for deferred payment. As a result of innovation of money as a medium of exchange creditors give credit in terms of money and the debtors accept the credit in terms of money. The advantage of this system is that the creditors easily gets the return of their money with interest (if agreement regarding interest payment exists). This is very important for the present day credit modern economy.

4. Store of value:

Wealth is saved mainly in terms of money money is liquid asset. Money is a frozen or coagulated purchasing power. People can save money for future expenditure or for exchange. People can give this purchasing power to others or under the authority upon this purchasing power for a fixed period of time. Apart from this, purchasing power can be converted into any other form. That is why, money is called liquid asset.

MEANING OF FINANCIAL SYSTEM

According to THE INSTITUTE OF OF CHARTERED FINANCIAL ANALYST OF INDIA (ICFAI), financial system is a mixture of of different institution, market, rules and regulations, customs, financial manager, analyst, transaction claims and liabilities.

According to Prof. Van Horne, the objective of financial system is to send efficiently the savings of the economy to those users who will invest the savings in real wealth or will use for consumption.

Thus the interrelated economic activities for services performed by the different financial institutions which work together II II full film the predetermined objective is called financial system.

ROLE OR SIGNIFICANCE OF FINANCIAL SYSTEM:

1. CAPITAL FORMATION:

Main yardstick of evaluation of the financial system of a country is the rate of capital formation and its trend. Amount of capital formation depends upon the the creation of savings, mobilization of savings and investment. The rate of capital formation is high of those countries whose financial system is developed and well organised.

2. FAVOURABLE ENVIRONMENT OF SAVINGS AND INVESTMENT:

An well organised and efficient financial system maximises the amount of income by giving security of savings and by keeping the interest of investors secured.

3. TRANSFER PROCESS OF SAVINGS AND INVESTMENT:

Financial system builds the bridge among the savers and investors. Responsibility of the financial institutions of the financial system is to transfer the financial assets from the saving surplus field (that is savings > investment) to the saving deficit field (that is savings < investment).

4. PROCUREMENT OF FINANCE:

In financial system, representative agencies of the capital market are involved in one side and representatives agencies of the money market are also involved in the other side. In reality these representative agencies i.e. bank, insurance company , mutual fund amalgamate different types of savings, bank deposit, assets of bill market etc. And deliver this financial assets at the hands of the investors.

5. DIFFERENT TYPES OF SERVICES:

In efficient, modern and advanced financial system, transactions are done through cheque, bank draft, credit card, debit card, e – commerce, e – business etc instead of directly through money. As a result both 8 time and money e r saved.

6. SOCIAL SECURITY:

Different institutions of the financial systems, for example, insurance company, investment trust arrange social security system through different types of scheme e.g.pension schemes, provident fund, Life insurance etc. So it plays an important role to increase the standard of living of people of the country.

7. TO PATRONIZE FOREIGN TRADE:

At present importance of foreign trade has increased to a great extent due to globalisation. Different rules and regulations of the government and the central bank should be obeyed for monetary transaction in foreign trade.

8. ORGANISE PUBLIC FINANCE:

Intermediary institutions of the financial system help in economic development by organising income -expenditure of the government of the country.

9. CREATION OF PUBLIC CONFIDENCE:

Economic development of the country depend on the transparency of the functioning of the component of financial system. Savings and investment may increase if the financial system can earn confidence of the public. Otherwise if the financial system fails to earn confidence of the public then propensity to save and investment (that is to say the willingness to save and invest) may decrease due to the fear of being cheated.

10. ECONOMIC DEVELOPMENT:

According to Gurley and Shaw, an interdependency exist among financial system and economic development. If financial system is immature then it hampers economic development. Economic development can be confirmed by increasing the rate of real national income by improving the economic structure through financial system. Thus economic development and economic growth of a country largely depend on the efficiency of the financial system of that country.

<u>COMPONENTS OF THE FINANCIAL SYSTEM</u>

The main components of the financial system can be divided into five groups.

* FINANCIAL INSTITUTIONS
* FINANCIAL MARKET
* FINANCIAL INSTRUMENTS OR FINANCIAL ASSETS
* FINANCIAL SERVICES
* FINANCIAL REGULATORS.

The five components of the financial system are now discussed below:

- ***<u>FINANCIAL INSTITUTIONS:</u>***

The institutions which are attached with financial activities generally called Financial institutions.They are attached with the financial and capital type transactions.

Classification of Financial institutions:

Financial Institutions can be classified mainly in three groups namely,

1. Financial Intermediary institutions

2. Financial non – intermediary institutions

3. Other Financial institutions.

Again

1. Financial intermediary institutions can be divided into to 2 groups

a. Banking intermediary institutions(for example commercial banks, SBI, HDFC etc.

b. Non- banking intermediary institutions.

Further, Non – banking intermediary institutions into two groups

i)Organised Financial institutions(like LIC ,GIC etc.)

ii)Unorganised Financial institutions(e.g. indigenous bankers).

- ***FINANCIAL MARKET:***

Market which helps in the transaction of different types of financial assets and performs different financial functions is called financial market. In the financial market investors get the chance of investment and the business institutions can collect necessary finance. It helps in maintaining the flow of money and flow of capital. In this market Financial institutions, different agents, brokers, businessmen, creditors, savers and others take part in financial demand and financial supply.

Classification of financial market:

Financial Market is mainly of two types.

1.Money Market:

A market in which transaction with short term financial assets or financial instruments is done, is called money market. In this market transaction of commercial hundies, treasury bills etc. Is are done. Money market exist both in organised and unorganised form.

The participating institutions in this market are Central bank, commercial bank, exchange bank, rural bank, indigenous bank etc.

2.Capital Market:

Well organised financial market from which long term supply of money is given to industry, trade and commerce is called capital market. The participating institutions of the capital market are mutual fund, insurance company, development banks, government investment institutions etc.

According to the nature of work performance, capital market can be divided into two groups.

* Primary market or new issue market (NIM)

* Secondary market or share market

Primary market or new issue market is a market where new share, debentures etc.of the companies are issued i.e. sale and purchase of new securities take place is called primary market or new issue market or NIM. New securities mean the securities which are not issued to the investors previously (first time being distributed by the companies in the market). In this market companies distribute new securities through public placement process the investors purchase the securities directly.

Secondary market or share market please the market where sale and purchase of old securities take place i.e. the market where the transaction of previously issued securities take place is the secondary market or share market. In this market liquidity of of long term securities are maintained. Actually this is the ready market of sale and purchase of listed securities. Those who purchase share in the primary market sale in the security market in case of necessity i.e. purchasers of primary market are treated as sellers in the secondary market.

- ***FINANCIAL INSTRUMENTS OR FINANCIAL ASSETS***:

Claim of future due from any person aur institution is called financial instruments of financial assets. For example distributed share and debenture of the company or corporation, government securities, Government treasury bills, commercial papers etc. Financial instruments help financial markets and financial intermediaries because through these financial assets financial markets and Financial intermediaries can distribute fund from the creditor to debtor. Financial instruments can be of different types on the basis of saleability, liquidity, risk, income, transaction and above all the need of the supplier and user of fund.

Types of classification of financial instruments or financial assets:

Financial Instruments are mainly classified in three groups:

- Short term financial instruments:

Financial instruments whose period of time is small, generally within one year are called short term financial instruments. That is the issuing institution return the money with fixed rate of interest of these instruments to the investors within one year.

Examples:

i) Short term Government treasury bills
ii) Short term receipt of fixed deposit of the banks etc.
iii) Medium term financial instruments:

Financial instruments whose period of time is generally between one year to five years are called medium term financial instruments.

Examples:

i) Term bond
ii) Certificate of of deposits issued by government, semi- government and private companies.
iii) redeemable preference share or debentures issued by the company.
iv) Long term financial instruments:

Financial Instruments whose period of time is long, generally five years or more are called long term financial instruments.

Examples:

i) Different type of long term share
ii) Long term debentures
iii) long term securities.

- ***FINANCIAL SERVICES:***

Different types of finance related services which Financial institutions give to to investors and business establishment are call Financial services. Important functions of financial services at to make guarantee of supply of alternative capital indirectly to to industrial establishment, supply of venture capital, financial advice, rediscounting of of commercial bills etc.

Types of financial services:

A. Fund based or asset based Financial services

B. Fee based or advisory based Financial services

A.Fund based or asset based Financial services:

Services rendered by Financial institutions to persons of farms by providing financial asset, reduction of risk etc. Is called fund based or asset based financial services.

Examples of Fund based or asset based financial services are

1. Leasing system

2. Hire purchase system

3. Debt factoring system

4. Discounting of bills

5. Venture capital fund

6. Insurance services

7. Housing finance

B.Fee based or advisory based services :

Financial institutions which give valuable advice for sorting out the problems of distribution of share at the time of inception of the company, determination of capital structure and composition of capital etc. Against fees is called fee based or advisory based financial institutions. The services which these financial institutions give on the basis of fees is called fee based or advisory based Financial services.

1. Share issue management

2. Portfolio management

3. Merchant banking services

4. Corporate counselling

5. Merger and acquisition

6. Capital reconstruction or capital reorganisation.

- ***FINANCIAL REGULATORS***

The institutions of associations which regulate financial system are called financial regulators.regulation of different components of the financial system is very essential for proper functions of the financial system.Main objective of the financial regulators of the financial system are to maintain transparency of financial market and financial functioning, creation of investors confidence upon financial market, security of the investors, prevent financial scams of money market and capital market etc.

Important financial regulators of India

* Indian Ministry of Finance

* Reserve Bank of India

* Securities and Exchange Board of India (SEBI)

* Banking Regulation Act

* Company Law Board

* Insurance Regulatory and Development Authority.

* Securities Contract Regulation Act, 1956.