CHAPTER

1

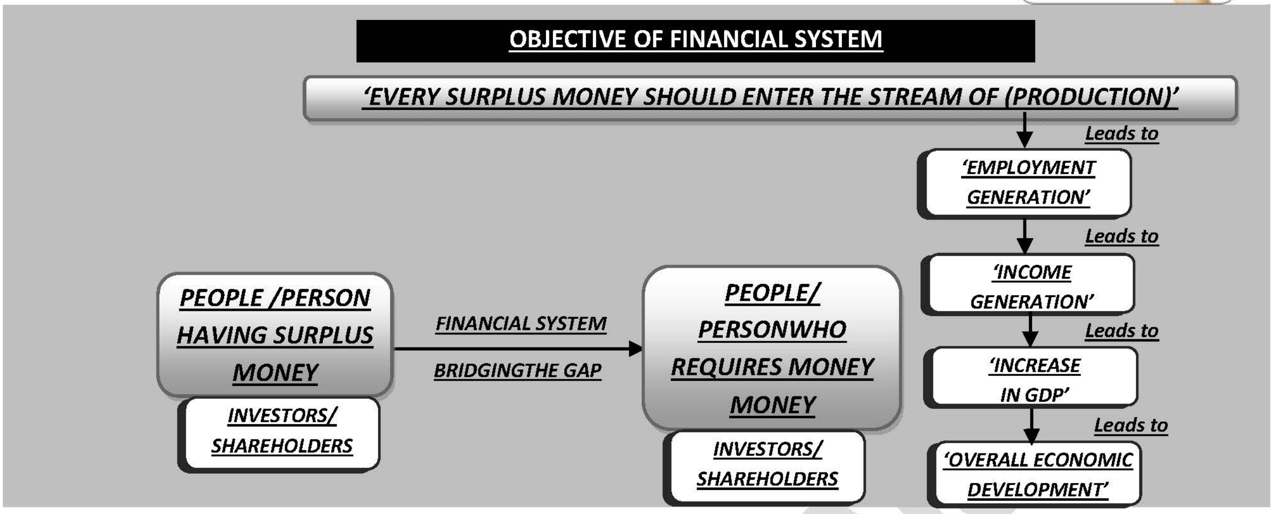
FINANCIAL SYSTEM

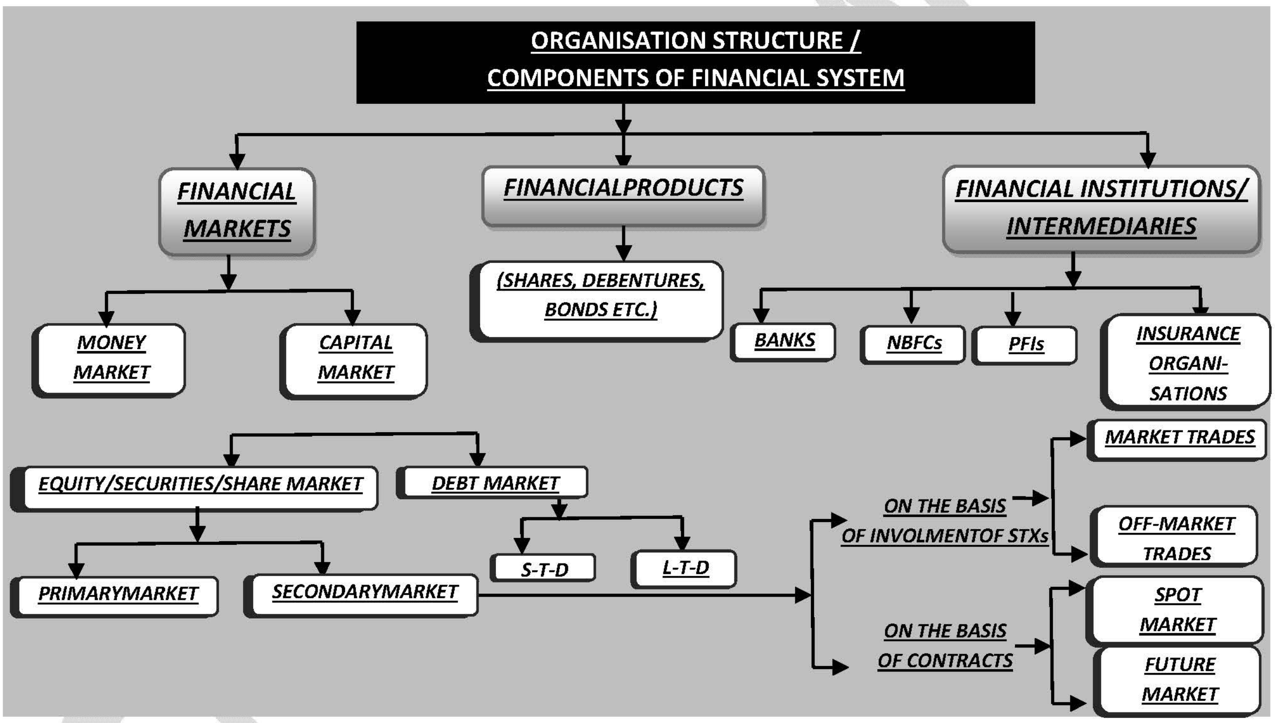
Covering-

- Original Structure of Financial System
- Financial Markets
- Money Market Vs. Capital Market
- Financial Products
- Financial Market Participants/Intermediaries
- Function of Financial Market
- Role of Securities/ Capital Market in Economic Growth
- Regulatory Framework for Securities Market

EXPECTED MARKS COVERAGE (5 to 10)

Space for
CHART NO.
Live Lecture





Space for
Additional Writing
Live Lectures

FINANCIAL SYSTEM

Every modern economy is based on a sound financial system which helps in economic growth by encouraging savings habits, mobilising savings from households and allocating savings into productive usage such as trade, commerce, manufacture etc.

A financial system is a set of institutional arrangements through which financial surpluses are mobilised from the units generating surplus income and transferring them to the others in need of them. Financial system covers both credit and cash transactions.

ORGANISATIONAL STRUCTURE / COMPONENT OF FINANCIAL SYSTEM

<u>Broadly, organisational structure of financial .system includes various components i.e.</u>

1. **Financial Markets,**
2. **Financial Products /instruments.**
3. **Financial Market Participants /intermediaries.**

FINANCIAL MARKETS

Financial markets provide channels for allocation of savings to investment. These provide a variety of assets to savers as well as various forms in which the investors can raise funds and thereby decouple the acts of saving and investment.

The financial markets have two major components; the <u>money market</u> and the <u>capital market</u>.

MONEY MARKET

The money market refers to the market where borrowers and lenders exchange short-term funds to solve their liquidity needs. Money market instruments are generally financial claims that have low default risk, maturities under one year and high marketability. Indian money market consists of formal and informal segments. The formal market comprises of RBI, various commercial banks, cooperative banks, UTI etc. Informal market consists of chit funds, nidhis, indigenous bankers etc. Money market instruments include treasury bills, commercial bills, certificate of deposit.

MONEY MARKET

- FORMAL (RBI, Banks etc.)
- INFORMAL (Chit Funds, Nidhi's etc.)

CAPITAL MARKET

The Capital Market is a market for financial investments that are direct or indirect claims to capital. It is wider than the Securities Market and embraces all forms of lending and borrowing. The capital market and in particular the stock exchange is referred to as the barometer of the economy.

Various factors influence the capital market and its growth. <u>These include</u>;-

1. level of savings in the household sector,
2. taxation levels,

Space for

CHART NO. ☐

Live Lecture

Space for

Additional Writing

Live Lectures

3. health of economy,
4. corporate performance,
5. industrial trends and
6. common patterns of living.

MONEY MARKET Vs. CAPITAL MARKET

Basis of difference	Money Market	Capital Market
1. Purpose	The money market fulfils the **short-term fund requirements** of Business Houses and Govt. of India.	The Capital market fulfils **Long-term funds requirements** of Business house like expansion of business, purchase of land & Building and machinery.
2. Maturity Period	It deals with raising and deployment of funds for short duration.	It deals with raising and deployment of funds for long duration.
3. Institutions involved	Government of India, Banks, Non-Banking Financial Institutions.	Any company registered in India, Bank and Insurance companies etc.
4. Market Regulator	This market is being regulated and controlled by RBI.	This market is being regulated and controlled by SEBI.
5. Instruments involved	Treasury bills, commercial bills, commercial papers certificate of deposits.	Stocks, shares, debentures, Bonds.
6. Volume of transactions	Very large as compared to capital market.	Less as compared to capital market.

SECURITIES MARKET

The Securities Market refers to the markets for those financial instruments/claims/obligations that are commonly and readily transferable by sale.
The Securities Market has two inter-dependent and inseparable segments, the new issues (primary) market and the stock (secondary) market.

➢ Primary Market

The market wherein resources are mobilised by companies through issue of new securities is called the primary market. The primary market provides the channel for sale of new securities.

The issue of securities by companies can take place in any of the following methods:

1. Initial public offer (securities issued for the first time to the public by the company);
2. Further issue of capital;
3. Rights issue
4. Bonus Issue. Etc

➢ Secondary Market

The secondary market enables those who hold securities to adjust their holdings in response to changes in their assessment of risk and return. They also sell securities for cash to meet their liquidity needs.

Space for

CHART NO.

Live Lecture

Space for
Additional Writing
Live Lectures

Secondary market essentially comprises of stock exchanges which provide platform for purchase and sale of securities by investors. The trading platform of stock exchanges is accessible only through brokers and trading of securities is confined only to stock exchanges. The stock market or secondary market ensures free marketability, negotiability and price discharge.

Secondary market has further two components.

1. First, the **spot market** where securities are traded for immediate delivery and payment.
2. The other is **futures market** where the securities are traded for future delivery and payment.

Another variant is the **options** market where securities are traded for conditional future delivery. Generally, two types of options are traded in the options market. A **put option** permits the owner to sell a security to the writer of the option at a pre-determined price before a certain date, while a **call option** permits the buyer to purchase a security from the writer of the option at a particular price before a certain date.

Difference between Primary and Secondary Market

Basis for comparison	Primary Market	Secondary Market
Meaning	The market place for issuing fresh securities	The market place for trading issued securities
Objectives	To raise funds	Capital Appreciation
Scope	Includes issuance of new securities through Initial Public Offer (IPO)	Includes the further trading of securities already offered to the public
Another name	New issue market	After issue market
Purchasing of securities	Investors can purchase securities directly from the Company	Purchase and sale of securities is done by the investors among themselves
Financing	Primary market provides funds to new and old companies for their expansion and diversification	It does not provide funding to companies
Parties to transactions	Company and Investors	Investors among themselves
Intermediaries	Underwriters	Brokers
Price	Price is fixed	Price fluctuates i.e. depends on demand and supply forces
Utilisation of fund	Fund gained from primary market becomes the capital of the company	Fund received from secondary market becomes income of investors

DEBT MARKET

Debt markets are markets for the issuance, trading and settlement in fixed income securities of various types and features. **Fixed income securities** can be issued by almost any legal entity like central and state governments, public bodies, statutory corporations, banks and institutions and corporate bodies.

FINANCIAL PRODUCTS / SECURITIES / INSTRUMENTS

"Securities" is defined in the Securities Contracts (Regulation) Act, 1956 to **include shares, scrips, stocks, bonds, debentures, or other marketable securities of like nature** of any incorporate company or body corporate, government securities, derivatives, units of collective investment scheme, any other instruments so declared by the central government.

Space for

CHART NO. $\boxed{}$

Live Lecture

Space for
Additional Writing
Live Lectures

There are a set of economic units who demand securities in lieu of funds and others who supply securities for funds. These demand for and supply of securities and funds determine, under competitive market conditions in goods and securities market, the prices of securities.

FINANCIAL / CAPITAL MARKET PARTICIPANTS / INTRMEDIARIES

A. CAPITAL MARKET INVESTMENT INSTITUTIONS

In any economy, financial Institutions play an important role because all the financial dealings and matters are handled and monitored by such Institutions. The major components of financial Institutions are banks, insurance companies, investment companies, consumer finance companies, and other specialized financial institutes. These institutions provide a variety of financial products and services to fulfil the varied needs of the commercial sector.

The Government of India, in order to provide adequate supply of credit to various sectors of the economy, has evolved a well-developed structure of financial institutions in the country.

These financial institutions can be broadly categorised into All India institutions and State level institutions

NATIONAL LEVEL INSTITUTIONS

1. **ALL-INDIA DEVELOPMENT BANKS (AID Bs):-**

   Includes those development banks which provide institutional credit not only to large and medium scale enterprises but also help in promotion and development of small scale industrial units.

   Following are the banks which caters to the need for the growth of different sectors on India :

   1. **Industrial Development Bank of India (ID BI):-** It was established in July 1964 as an apex financial institution for industrial development in the country. It caters to the diversified needs of medium and large scale industries in the form of financial assistance, both directly and indirectly and also promote institutions engaged in industrial development.
   2. **Industrial Finance Corporation of India (IFCI):-**It was the first development finance institution set up under the IFCI Act 1948, in order to pioneer long-term institutional credit to medium and large scale enterprises.
   3. **Small Industries Development Bank of India (SID BI):-**It was set up by the Government of India in April 1990, as a wholly owned subsidiary of IDBI. It is the principal financial institution for promotion, financing and development of small scale industries in the economy.
   4. **Industrial Investment Bank of India Ltd (II BI):-**It was set up in 1985 under the Industrial reconstruction Bank of India Act, 1984, as the principal credit and reconstruction agency for sick industrial units. It was converted into IIBI on March 17, 1997, as a full-fledged development financial institution.

2. **SPECIALISED FINANCIAL INSTITUTIONS (SFIs):-**

   These are the institutions which have been set up to serve the increasing financial needs of trade and commerce in the area of venture capital, credit rating and leasing, etc.

   Following institutions are considered as SFIs in our country:

   1. **IFCI Venture Capital Funds Ltd (IVC F):-** IVCF formerly known as Risk Capital & Technology Finance Corporation Ltd (RCTC), is a subsidiary of IFCI Ltd. It was promoted with the objective of broadening entrepreneurial base in the country by facilitating funding to ventures involving innovative product/process/technology.

Space for

CHART NO.

Live Lecture

Space for

Additional Writing

Live Lectures

2. **ICICI Venture Funds Ltd:-** Formerly known as Technology Development & Information Company of India Limited (TDICI), it was founded in 1988 as a joint venture with the Unit Trust of India. Subsequently, it became a fully owned subsidiary of ICICI. It is a technology venture finance company, set up to sanction project finance for new technology ventures.
3. **Tourism Finance Corporation of India Ltd. (TFCI):-** It is a specialised financial institution set up by the Government of India for promotion and growth of tourist industry in the country. Apart from conventional tourism projects, it provides financial assistance for non-conventional tourism projects like amusement parks, ropeways, car rental services, ferries for inland water transport, etc.

3. INVESTMENT INSTITUTIONS:-

These are the most popular form of financial intermediaries, which particularly catering to the needs of small savers and investors. They deploy their assets largely in marketable securities.

Following are the Investment Institutions established by the Government :

(a) Life Insurance Corporation of India (LIC):-It was established in 1956 as a wholly-owned corporation of the Government of India. It was formed by the Life Insurance Corporation Act, 1956, with the objective of spreading life insurance much more widely and in particular to the rural area.

(b) Unit Trust of India (UTI):-It was set up as a body corporate under the UTI Act, 1963, with a view to encourage savings and investment. It mobilises savings of small investors through sale of units and channelises them into corporate investments mainly by way of secondary capital market operations.

(c) General Insurance Corporation of India (GIC):-It was formed by the enactment of the General Insurance Business (Nationalisation) Act, 1972(GIBNA), for the purpose of superintending, controlling and carrying on the business of general insurance or non-life insurance such as accident, fire, etc.

STATE LEVEL INSTITUTIONS

Several financial institutions have been set up at the State level which supplement the financial assistance provided by the all India institutions. They act as a catalyst for promotion of investment and industrial development in the respective States.

They broadly consist of 'State financial corporations' and 'State industrial development corporations'.

1. **State Financial Corporations (SFCs):-** These are the State-level financial institutions which play a crucial role in the development of small and medium enterprises in the concerned States. They provide financial assistance in the form of term loans, direct subscription to equity/debentures, guarantees, discounting of bills of exchange and seed/ special capital, etc. SFCs
2. **State Industrial Development Corporations (SIDCs):-**These corporations have been established under the erstwhile Companies Act, 1956, as wholly-owned undertakings of State Governments. They have been set up with the objectives of promoting industrial development in the respective States and providing financial assistance to small entrepreneurs.

B. PARTICIPANTS OF CAPITAL MARKET

1. Qualified institutional buyers
2. Foreign portfolio investor
3. Alter native investment funds
4. Private equity

Space for

CHART NO.

Live Lecture

Space for

Additional Writing

Live Lectures

5.	Angel fund
6.	Anchor investors
7.	High net worth individuals
8.	Venture capital
9.	Pension fund

PENSION FUND

Pension Fund means a fund established by an employer to facilitate and organize the investment of employees' retirement funds which is contributed by the employer and employees. The pension fund is a common asset pool meant to generate stable growth over the long term, and provide pensions for employees when they reach the end of their working years and commence retirement.

Pension funds are commonly run by some sort of financial intermediary for the company and its employees like National Pension Scheme (NPS) is managed by UTIAMC (Retirement Solutions), although some larger corporations operate their pension funds in-house.

LEGISLATIONS

There are three defining Acts for pensions in India:

1.	**Pensions under the EPF & MP Act 1952**: These include the Employees Provident Fund, Employees Pension Scheme, and Employees Deposit Linked Insurance Scheme,
2.	**Pensions under the Coal mines PF & MP Act 1948**: These include Coal mines provident fund, Coal mines pension scheme & Coal mines linked insurance scheme.
3.	**Gratuity under the Payment of Gratuity Act, 1972**: There are other provident funds in India like Assam Tea Plantations PF, J&K PF, and Seamens PF etc.

Pensions broadly divided into two sector:

A- Formal sector Pensions

Formal sector pensions in India can be divided into three categories; viz pensions under an Act or Statute, Government pensions and voluntary pensions

B- Informal sector Pensions

This scheme will cover unorganized workers who are working or engaged as home based workers, street vendors, agriculture workers, construction workers, among others.

ATAL PENSION YOJANA (APY)

Government of India (GoI) is concerned about the old age income security of the working poor and is focused on encouraging and enabling them to save for their retirement. To address the longevity risks among the workers in unorganized sector and to encourage the workers in unorganized sector to voluntarily save for their retirement.

The GoI has therefore announced a new scheme called Atal Pension Yojana (APY)1 in 2015-16 budget. The APY is focused on all citizens in the unorganized sector The scheme is administered by the Pension Fund Regulatory and Development Authority (PFRDA) through NPS architecture. Under the APY, there is guaranteed minimum monthly pension for the subscribers ranging between ` 1000 and ` 5000 per month. The benefit of minimum pension would be guaranteed by the GoI.

Space for

CHART NO. ☐

Live Lecture

Space for

Additional Writing

Live Lectures

GOVERNMENT PENSION

Government pensions in India are referred under the Directive Principles of State Policy and are therefore not covered under a Statute. The Government amended the regulations to put in place the new pension system.

The old scheme continues for the existing employees (i.e. those who joined service prior to January 1, 2004). Pensions for government employees would include employees of the central as well as the state governments.

(A) Central Government Pensions like Civil servants pensions, Defences, Railways, Posts. (B) State Government Pensions, Bank pensions like Reserve Bank of India (RBI), Public Sector Banks, National Bank for Agriculture and Rural Development (NABARD) and other banks pensions.

FUNCTIONS OF FINANCIAL MARKET/ SECURITIES MARKET / CAPITAL MARKET

(a)	The Securities Market provides a **linkage between the savings and the investment** across the entities, time and space.
(b)	It mobilises savings and channelizes them through securities into **preferred enterprises**.
(c)	The Securities Market also provides a market place for purchase and sale of securities and thereby ensures **transferability of securities**, which is the basis for the joint stock enterprise system.
(d)	The existence of the Securities Market makes it possible to satisfy simultaneously the **needs of the enterprises for capital and the need of investors for liquidity**.
(e)	The Securities Market allows individuals **who cannot carry an activity in its entirety within their resources** to invest. Individuals can attract enough investment from others to make a start.
(f)	The Securities Market allows to **diversify risk** among many ventures to offset gains and loss.

NKJ–CLASSROOM PRACTICE	
SCANNER	**Q. 1.** Explain the following Functions of Securities Market. **[June 2017, 3 Marks]**

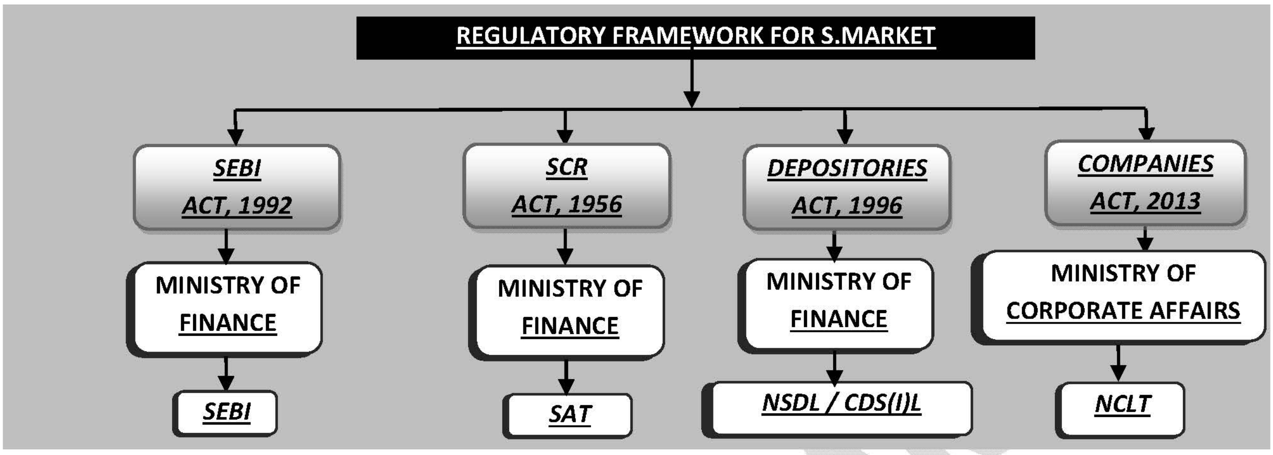
ROLE OF SECURITIES/ CAPITAL MARKET IN ECONOMIC GROWTH

A well-functioning securities market is conducive to sustained economic growth. The securities market fosters economic growth to the extent that: -

(a)	It increases the quantities of real savings and capital formation from any given level of national income,
(b)	It increases net capital inflow from abroad,
(c)	It raises the productivity of investment by improving allocation of investible funds, and
(d)	It reduces the cost of capital.
(e)	It forms the basis for well performing domestic corporate to raise capital in the international market

NKJ–CLASSROOM PRACTICE	
SCANNER	**Q. 1.** Explain the role of securities market in economic growth. **[June 2018, 5 Marks]**

Space for
CHART NO.
Live Lecture



Space for
Additional Writing
Live Lectures

REGULATORY FRAMEWORK FOR SECURITIES MARKET / CAPITAL MARKET

Following Laws play important role in administering securities market / laws: -

SEBI Act, 1992:

The SEBI Act, 1992 establishes SEBI with statutory powers for

(a) Protecting the interests of investors in securities,

(b) Promoting the development of the securities market, and

(c) Regulating the securities market.

Securities Contracts (Regulation) Act, 1956:

It provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent undesirable transactions in securities.

Depositories Act, 1996:

The Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security

Companies Act, 2013:

It deals with issue, allotment and transfer of securities and various aspects relating to company management.

RULES AND REGULATIONS

The Government has framed rules under the SCRA, SEBI Act and the Depositories Act. SEBI has framed regulations under the SEBI Act and the Depositories Act for registration and regulation of all market intermediaries, and for prevention of unfair trade practices, insider trading, etc.

REGULATORS

The **Ministry of Finance** regulates through the **Department of Economic Affairs - Capital Markets Division**. The division is responsible for formulating the policies related to the orderly growth and development of the securities markets (i.e. share, debt and derivatives) as well as protecting the interest of the investors.

In particular, it is responsible for :

(a) institutional reforms in the securities markets,
(b) building regulatory and market institutions,
(c) strengthening investor protection mechanism, and
(d) providing efficient legislative framework for securities markets.

SEBI – The Capital Markets Regulator

The Securities and Exchange Board of India (SEBI) was established in 1988 through an administrative order, but the Act was passed after about four years and it became a statutory and really powerful Institution only since 1992.

OTHER CAPITAL MARKET REGULATORS

Reserve Bank of India (RBI):

The Reserve Bank of India (RBI) is India's central bank, also known as the banker's bank. The RBI controls monetary and other banking policies of the Indian government.

Space for

CHART NO.

Live Lecture

Space for

Additional Writing

Live Lectures

Insurance Regulatory and Development Authority of India (IRDAI):

IRDAI is a statutory body formed under an Act of Parliament, i.e., Insurance Regulatory and Development Authority Act, 1999 (IRDAI Act 1999) for overall supervision and development of the Insurance sector in India.

Pension Fund Regulatory and Development Authority (PFRDA):

PFRDA is a statutory regulatory body set up under The Pension Fund Regulatory and Development Authority Act, 2013 with an objective to promote old age income security and protect the interests of NPS subscribers.

Space for
CHART NO.
Live Lecture

Space for
Additional Writing
Live Lectures

Q. 1.

Answer to Question No. 1:-

Q. 2.

Answer to Question No. 2:-