INDIAN FINANCIAL SYSTEM
Unit I

Syllabus of Unit I

Financial System and Its Components
Meaning, Significance and Role of the Financial System; Components of the Financial System; The structure of Indian Financial System.

The syllabus of the IFS paper (B.Com Hons Semester 3) focuses on two objectives. First, to sensitize the learner about the basic functioning of Financial System in general, and second, to make them aware of the structure and functioning of the different component parts of the Indian financial system.

Learning Objectives of Unit I

What is a "Financial System"	**Functions of a "Financial System"**	**The role and significance of the financial system of a country**
The component parts of a financial system	**What the different markets under a financial system are**	**Who are the regulators and participants in the Indian financial system**
What the important financial instruments are	**A few important concepts**	**A few sample questions**

We shall first provide a snapshot of

- The nature and definition of the financial system,
- Its main functions,
- Its role and significance,
- Its component parts, different markets under the financial system,
- Various participants and regulators of the Indian financial system, and
- The different important instruments that are transacted in different financial markets.

Later, we shall briefly explain a few important concepts. Finally, we shall provide a list of a few sample questions

Topic /Concept	Definition/ Explanation
Financial System	A **financial system** is a network of financial regulators, financial institutions, financial markets, financial instruments, and financial services that facilitate (i) transfer of monetary resources from one economic unit to another, and (ii) management of risk.
Functions of a Financial System	*(i) Encouraging/ mobilizing savings* *(ii) Facilitating investment* *(iii) Risk management* *(iv) Facilitating trade and other international economic transactions* *(v) Rendering various financial services*
Role/Significance of a Financial System	*(i) Efficient allocation of resources* *(ii) Capital formation* *(iii) Enhancing productivity in the economy* *(iv) Promoting growth and development, and hence, a better standard of living* *(v) Reduces risk and uncertainty, and thereby helps economic decision-making*
Components of a Financial System	*(i) Financial regulators, e.g. SEBI, RBI in India,* *(ii) Financial markets, e.g. money market, capital market, insurance market,* *(iii) Financial institutions, e.g. commercial banks, insurance companies, merchant bankers,* *(iv) Financial instruments, e.g. call money, repo, shares, debentures, bonds,* *(v) and financial services, e.g. credit rating, merchant banking, factoring.*
Markets under the Financial System	*(i) Money market (for short term instruments up to one year maturity),* *(ii) Capital market (for instruments of more than one year maturity),* *(iii) Insurance market (both life and non-life)* *(iv) Credit market* *(v) Foreign exchange market* *(vi) Financial Services market* **The above is an instrument-based classification. Other classifications are also possible in respect of some markets. For example:** A. Money market and capital market can both be divided into (i) **Primary market** (for new issues), (ii) **secondary market** (for further transactions of already issued instruments) B. **Organised** and **Unorganised** markets (depending upon the transparency & uniformity of rules, regulatory structure, information dissemination etc)
Different Participants in a	**Money market participants**: ***(i) Commercial Banks, (ii) Primary Dealers and Satellite Dealers, (iii) Corporate Houses, (iv) Government, (v) Money market Mutual Funds,***

financial system and Regulators in Indian financial System	*(vii) Financial Institutions like Insurance companies, and (vii) others* **Money market Regulator in India:** ***Generally, the Central bank of a country regulates the money market. In India, Reserve Bank of India is the regulator*** **Capital market participants: (i) Corporate Houses, (ii) Mutual Funds, (iii) Financial Institutions, (iv) Merchant bankers, (v) Brokers, (vi) Others, including the public** **Capital market regulator in India: Securities & exchange Board of India (SEBI), RBI** **Insurance market participants: (i) Life Insurance companies, (ii) General Insurance companies, (iii) Corporate houses, (iv) Public, (v) Others** **Insurance market regulator in India: Insurance Regulatory & Development Authority (IRDA)** **Financial Services market participants: (i) Merchant bankers, (ii) Credit rating agencies, (iii) Leasing/ Hire purchase companies, (iv) Factors and Forfaiters etc.** **Financial market regulators in India: (i) SEBI, (ii) RBI, (iii) IRDA** **Foreign Exchange market participants: (i) Commercial banks, (ii) Authorised dealers, (iii) Corporate houses, (iv) Government, (v) Public** **Forex market regulator in India: RBI**
Instruments	**Money market instruments: (i) Repos, (ii) Call Money, (iii) Treasury Bill, (iv) Commercial Paper, (v) Certificates of Deposit etc.** **Capital market instruments: (i) Shares, (ii) Debentures, (iii) Bonds (both convertible & non-convertible)** We can also mention derivatives, such **as options**, **futures** etc. which are relevant not for the capital market, but for the foreign exchange market, commodity markets (such as global oil market) etc.

A few important concepts:

Direct Finance Vs indirect finance

Direct Finance refers to a financial transaction between a fund-surplus unit (such as a lender) and a fund-deficit unit (such as a borrower) which takes place without the presence of a financial intermediary (like a commercial bank or an insurance company or a mutual fund).

On the other hand, **indirect finance** refers to a financial transaction between a fund-surplus unit and a fund-deficit unit which takes place through an intermediary.

Examples of direct finance include shares issued to the public, individuals subscribing to an issue of government bonds etc.

On the other hand, examples of indirect finance include transfer of funds between a lender and a borrower through a commercial bank or an insurance company. When we put our money in a bank, we do not know who will ultimately borrow the money. We have separate terms of agreement with the bank compared to the terms of agreement between the bank and the borrower.

It may be noted that the mere presence of a broker in the process of a transaction does not make it **indirect finance**. For example, if person X buys a government bond through an agent, there is still a lender borrower relationship between person X and the government. No **transmutation effect** is involved. To make it indirect finance, there must some asset-liability transmutation.

The differences between direct finance and indirect finance are presented below:

	Direct Finance	Indirect Finance
1.	Direct financial transaction between a fund-surplus unit and a fund-deficit unit	Financial transaction between a fund-surplus unit and a fund-deficit unit **through a financial intermediary**
2.	The transaction involves just two parties - one borrower and one lender	The transaction involves three parties- one lender, one intermediary and one borrower
3.	The investor faces problems regarding finding a creditworthy borrower.	The investor does not look for a creditworthy borrower, instead, the intermediary does.

A Note on the Foreign exchange market

The foreign currency or foreign exchange market (we shall call it the **forex market** hereafter) is a decentralized worldwide market in which currencies of different countries are traded. This market is required in order to facilitate the settlement of receivables and payables arising from international movements of goods, services and capital. Currently, it is the world's largest financial market.

One difference of the forex market from other financial market is that it is unregulated. Individual countries may have their own regulations and restrictions, but on an international scale, it is free. **No institution acts as an intermediary between the parties** to ensure or guarantee that they comply with their respective obligations. Each transaction is closed with a private contract between the parties.

The forex market remains open 24 hours a day except during the weekends. Among the most important international centres, we may mention Tokyo**, Singapore, Sidney, Hong Kong, London, Zurich, New York etc.**

The forex market can be divided into three basic segments – (i) the Spot market, (ii) the Forward market, and (iii) the Derivative market (Futures and Options). The second and the third are used to manage or hedge risks. Thus, the two basic functions of a Forex market are:

- To facilitate the settlement of receivables and payables arising from international movements of goods, services and capital, and

- To manage or hedge risks associated with international economic transactions due to exchange rate fluctuations

A few Sample questions

1. What do you mean by a financial system?
2. What are financial intermediaries? What role do they play? (Hint: Direct Vs Indirect finance)
3. Distinguish between Direct finance and Indirect finance
4. What role does the financial system play and why it is considered to be so important?
5. Clearly describe the component parts of the Indian financial system.
6. Describe the structure of the Indian financial system.