Chapter 2

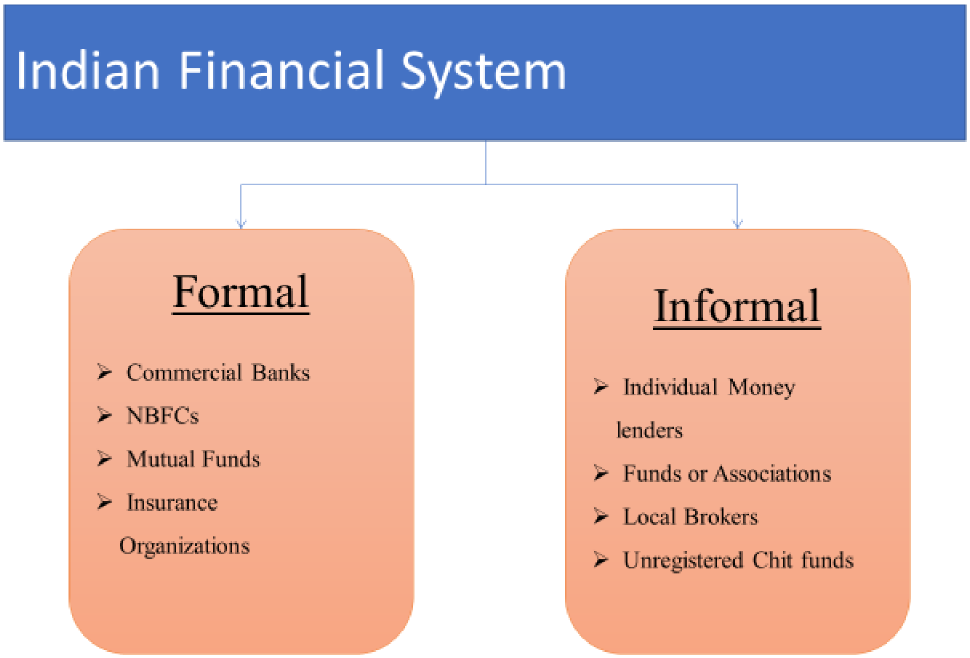
Financial System

A financial system is the system that covers financial transactions and the exchange of money between investors, lender and borrowers.

Various components of financial systems are- Financial markets, institutions, financial services, and financial instruments.

The main function of a financial system is the collection of savings and their distribution for investment, thereby stimulating capital formation and, to that extent, accelerating the process of economic growth. The financial system is a link between the savers (savings-surplus economic units) and the investors (saving-deficit economic units). It is made up of all those channels through which savings become available for investment.

The organization of the financial system comprises of three inter-related components, namely, financial intermediaries, financial markets and financial assets/instruments (securities).



Financial markets are a significant component of the financial system.

A financial market is a wide term which means any marketplace where sellers and buyers interact in the trade of financial assets such as bonds, equities, mutual fund units, derivatives and currencies.

They are not a source of funds, but they act as a facilitating organisation and link the savers and investors, both individual as well as institutional.

As facilitating organisations, financial markets provide a wide variety of specialist institutional facilities.

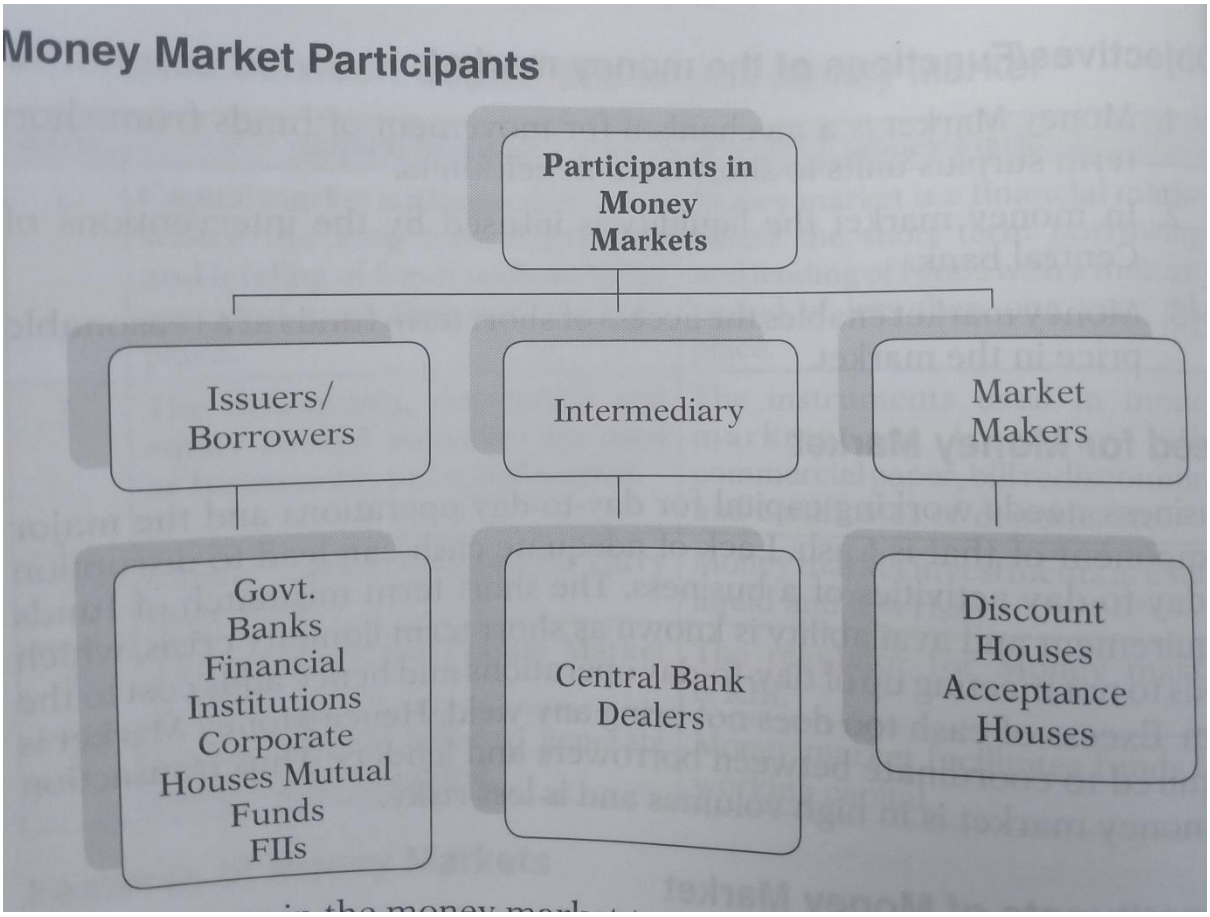
Based on the nature of funds which are their stock-in-trade, they are classified into: (i) money markets and (ii) capital/securities markets.

Money market is a market for dealing in monetary/financial assets of a short-term nature, generally less than one year. Its broad objectives are to provide (i) an equilibrating mechanism for evening out short-term surpluses and deficiencies in the financial system, (ii) a focal point of central bank (RBI) intervention for influencing liquidity in the economy through a variety of instruments, and (iii) a reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable price/cost.

The money market organisation comprises of a number of interrelated sub-markets such as call market, T-bills market, commercial bills market, CP market, CD market, repo market and so on.

The **organised sector** of the money market con-sists of the Reserve Bank of India, commercial banks, companies lending money, financial inter-mediaries such as the Life Insurance, Credit and Investments Corporation of India, Unit Trust of India, Land Mortgage Banks, Cooperative Banks, Insurance Companies etc. and call loan brokers, and stock brokers.

The **unorganised sector** of the money market is largely made up of indigenous bankers, money lenders, traders, commission agents etc., some of whom combine money lending with trade and other activities.



Capital/securities market is a market for long-term funds.

It has two segments: primary/new issue market and secondary/stock exchange/market.

The **primary market** deals in new securities, offered to the investors for the first time. It performs a triple-service function, at the different stages of the issue, namely, origination, that is, investigation, analysis and processing of new issue proposals; underwriting; and distribution of securities to the investors.

Secondary Market →

1. A secondary market is a market where securities are offered to the general public after being offered once in the primary mkt.

2. It provides an exist route or liquidity to existing investors.

3. All commodity, stock exchanges and over the counter market serve as secondary market.

4. Prices of securities are determined on a continuous basis. Thus, providing instant valuation. It is also called as "After Mkt."

Functions / Features / Significance of Secondary Market →

1. Provides liquidity and marketability to existing securities.

2. Provides continuous valuation of securities.

3. Contributes to economic growth.

4. Plays a vital role in smooth functioning of corporates by mobilization of savings. It also helps in spreading equity cult.

5. It acts as a barometer of general economic progress in a country.

6. It functions under strict regulations thereby ensuring safety of transactions.

7. It provides a platform for couporate actions (dividend declaration, bonus issue, rights issue, stock splits, etc.) to take place.

Stock Exchange →

1. As per the Securities Contract Regulation Act (SCRA), 1956, stock exchange is an association, organization or body of individuals whether incorporated or not, established for the purchase of assisting, regulating and controlling the business of buying, selling securities.

2. It is an organized market place which facilitates the process of issue and redemption of securities, payment of dividends etc.

Demutualization →

1. It means the segregation of ownership and management from the trading rights of the members of a stock exchange as per SEBI norms.

2. Prior to demutualization stock exchanges were owned, controlled & managed by brokers leading to conflict of interest.

3. After demutualization the exchange takes a form of a joint stock company where the stock brokers are the shareholders of that company.

4. The trade on the stock exchange can be undertaken only by its member, ie stock brokers with a membership ticket.

5. In May 2007, 51% of equity share capital of BSE was placed with Indian corporates non-broker member, private equity funds, etc.

Bullish Mkt.

1. A bull market is a market when the stock Price are raising.

2. A bullish sentiments indicates expectations of raising prices or raising mkt.

Bearish Market

1. It is a mkt. when stock prices are falling and it is tough for investors to pick up profitable stocks.

2. A person is said to be a bear if he believes the stock prices/stock market is going to fall.

Categories of Players → (in Stock Market)

Investor

(a) An investor participates in the mkt. over long period of time and holds stocks to maximise the returns.

(b) They are more concerned with fundamental factors. They can be further sub divided into 2 categories:

(i) Retail Investors (individuals).

(ii) Institutional Investors (both domestic and foreign)

Traders

(a) These are the people who are involved with frequent buying and selling of securities within a short period of time.

MAJOR STOCK EXCHANGES IN INDIA

A. Bombay Stock Exchange → (BSE)

1. BSE, Asia's first stock exchange established in 1875.

2. Formally organized as BSE after demutualization.

3. Main stock index of BSE is SENSEX 30 – Sensex, comprises of 30 stock.

4. Depository services for BSE are provided by CDSL.

5. Real time trading takes place on BOLT. Ie BSE online Trading System.

6. Other index of BSE are BSE 100, BSE 200, BSE 500.

7. There is a dollar (&) linked version of BSE 200 known as DOLLEX 200. There are also sectoral index (BSE PSU index)

B. National Stock Exchange → (NSE)

1. Incorporated in 1992 and started functioning since 1993.

2. It is the first stock exchange to provide fully automated screen based electronic trading system called NEAT.

3. It is also the world's 3rd largest stock exchange.

4. Main index is NIFTY-FIFTY comprising of 50 stocks.

5. Depository services are provided by NSDL.

6. Derivative Trading started in June 2000.

7. Trade on NIFTY also takes place in the derivative segment of Singapore stock exchange.

8. NSE pioneered the trading of ETF, Exchange Traded Fund (eg. Gold ETF, where 1 unit Gold ETF = 1 gram Gold)

Insider trading –

Trading on material information which is not accessible to public at large with a view to earn profits on the trade.

Clearing and Settlement –

1. Clearing is the process of determining the obligations when a trade takes place.

2. Whereas settlement is a process which involves legal transfers of funds and securities on the settlement date.

3. In India, the clearing and settlement process is carried out by NSCCL (National Securities Clearing Corporation Limited).

4. The pay-in and pay-out of obligations for funds and securities are determined latest by T + 1 day.

5. The settlement day, when obligations are discharged is maximum T + 2 in India.

Difference between Primary Market and Secondary Market

The following are the points of differences between primary market and secondary market:

S.No.	Primary Market	Secondary Market
1	Primary Market is commonly known as the New Issue Market.	Secondary Market is commonly known as the After-Issue Market
2	It is the marketplace where securities are issued for the first time.	It is the marketplace where the securities already issued in primary market are traded.
3	In primary market, securities are directly issued by the companies to investors.	In secondary market, securities are transferred from one investor to another.
4	Prices of securities are either fixed by issuer or by book building process. The securities can be issued at par, premium or discount.	In secondary market, prices of securities keep on fluctuating depending on market demand and supply.
5.	Intermediaries involved in the primary market are underwriters and investment bankers	Stock brokers are the intermediaries involved in the secondary market.
6.	The sale proceeds from the primary market go to the issuing company.	The sale proceeds from the secondary market go to the investor, and not the issuing company.

7.	There is no specific location or physical existence of primary market.	Secondary market exists in the form of stock exchanges.
8.	Primary market has no role in providing liquidity to securities.	Secondary market provides liquidity to the securities.

Participants in the Capital Market

Capital Markets perform an important function of mobilising funds from surplus units to deficit units, In this process of capital mobilisation, following are the major participants:

1. Savers- These are the units having surplus funds which they want to save. They are also the investors in the capital market who invest in various capital market instruments depending upon their objectives.

2. Borrowers- These are the deficit units. They have profitable invest opportunities but lack the necessary finance. Thus, they issue the instruments through capital market to procure the funds.

3. Financial Intermediaries- Financial intermediaries bridge the gap between savers and the borrowers by providing various financial services like merchant banking, underwriting, brokers, sub brokers, custodians, depositories, etc.