Financial Institutions and Markets
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Lecture – 01
Introduction to Financial System

Good morning, welcome to the course on Financial Institutions and Markets. Today we will be discussing about so the introduction part, where you will have the idea that how to define this financial system or financial institutions and markets and what are those functions of this particular system and how the financial markets are structured or how the financial system in general structured into different financial institutions and markets.

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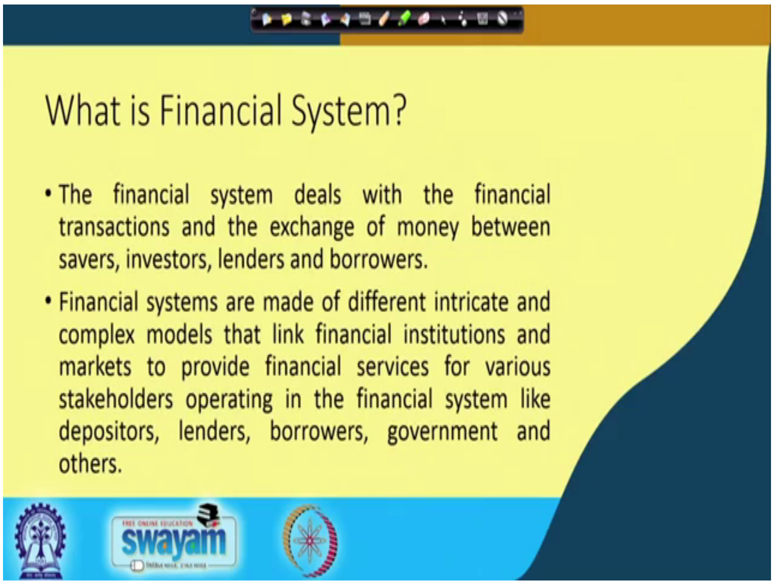

So, if you see that what exactly the financial system is, the financial system basically deals with the financial transactions and the exchange of money between servers, investors, lenders and borrowers

If you see the each word, what this particular word defines? Servers means the household sector or the corporate sector mostly the household sectors are the savers who wants to save their money for specific reasons and the investors are those people who wants to use that particular savings to generate certain profits mostly the corporate sectors are responsible for that. Then we have lenders the lenders are basically the financial institutions or the banks who is lends the money for specific reasons that reason includes maybe the buying the house or maybe investing the money in the market or buying any other kind of consumable products.

So, for any other thing always the lenders or the banks or financial institutions provide the loan to the different stakeholders and the borrowers are basically the individuals and as well as some other financial institutions who wants to borrow the money from the financial system. So, the financial system in general tries to integrate these stakeholders for the transaction purpose and also to exchange the money between them. So, in general overall if you see the basic job of the financial system is to make a relationship between the different stakeholders like the savers, investors, lenders for borrowers and other market participants who are existing in this particular system.

So, in general now we can define that what exactly it does. So, in this context the basic job of the financial system is to provide the financial services and financial services means it basically tries to provide certain kind of service to the different stakeholders to maximize their return or to fulfill the requirements in terms of the financial requirements or the requirements are mostly related to the financial aspects. So, therefore, now we can define it this way the financial systems are made of different integrate and complex models that link the financial institutions and markets to provide the financial services for various stakeholders operating in the financial system like depositors, lenders, borrowers, government and others.

So, here we are depositing the money and the commercial borrowers or the corporate sector tries to take that particular loan and uses it for some specific investments and finally, some return is realized and by that the maximum amount of return can be generated from the market and finally, the money can be circulated and as well as the flow of the particular money comes to the system which helps in the different kind of growth activities in the economy at a large. So, therefore, the financial system basically tries to make a integration between the different stakeholder or make them together by that the money can come to the market in a systematic way and finally, the services or the financial services can be realized from this.

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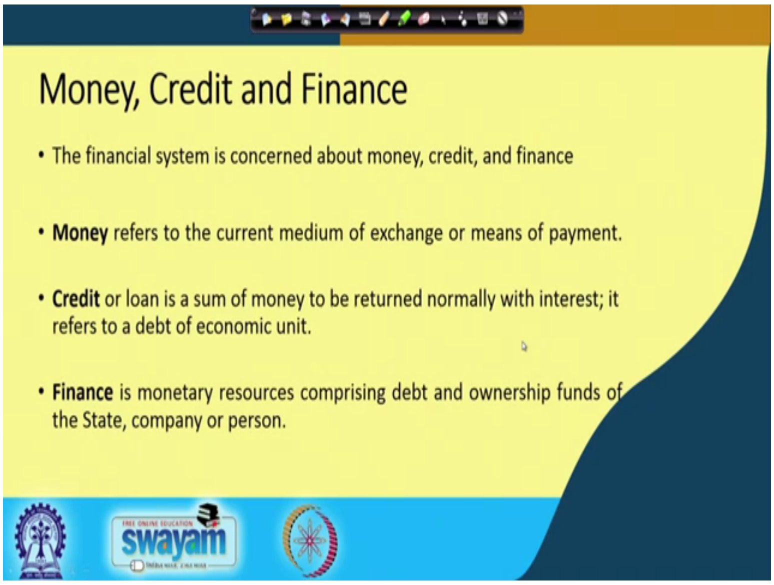

So, in this context there are three words people always use whenever they try to discuss about or they try to relate about the financial system ah; one is money, second one is credit and third one is the finance. So, these are the terms which are largely or mostly used by the people or by the different participants in the financial system.

So, if you see in a layman point of view money means money the rupee or the particular currency would people use it for different reasons that the lemon prospective. But if you try to find out a proper definition of the money the money is nothing, but the medium of exchange it is a means of payment. If anybody wants to define the money in a very systematic or maybe standard way, then we can say that money is particular instrument or money is basically a particular medium of exchange or a means of payment on a bar we transact in the financial system or any other market which exists in this particular economy.

So, therefore, money refers to the current medium of exchange or the means of payment. So, that is the way money in aggregate sense or in real sense can be defined there. Whenever you talk about the credit all of you might have already aware about that we have two things that you might have seen your a bank passbook the some money is credited someone is debited. So, whenever we talk about the credit it is basically whenever we expecting something to be realize from that and if you have some kind of credit that is basically always used as a positive sense which can generate certain revenue in the future.

So, whenever you talk about credit in an aggregate sense in a larger sense it is basically the commercial banks provide the credit to the different kind of other companies or corporate sector and also individuals expecting certain interest from that. And mostly in in a true sense credit is nothing, but the loan which is given by the commercial banks to the different stakeholder which are participating in the financial market by that the commercial bank can generate certain revenue out of this and as well as the particular person who takes that loan, they can utilize that particular resources, utilize that particular finance for the specific purposes for what purpose they have taken that loan that loan is basically can be utilized for that specific purpose. And finally, in the end they have to pay certain interest to the commercial banks.

So, therefore, if anybody has taken a loan we consider this is a debt for them or if it is for us it is a liability if any individual takes a loan, we consider this is the liability for the individual. But however, we talk about the commercial bank prospective or any other financial institutions who provide the loan to us for them. It is basically an asset because from this particular kind of loans they generate certain revenue, they generate certain interest which basically helps them to run their business and finally, because they do the financial business and we get this particular money from them to fulfill our requirements and also to utilize that particular money for specific reasons.

So, that is the way the credit in a financial sense we use in the financial system. Then we have the finance that is another what people always use what exactly the finance is. The finance is basically nothing, but it is a monetary resources comprising depth and the ownership of the fonts of the straight company or person I can give an example in this case. For example, a company wants to do the business and how the company into the business.

Company basically generate certain revenue by selling the products or maybe they basically produce certain products sell them in the goods market and generate certain kind of income from this and whatever cost they have incurred to produce that product and if you take a difference between the income what they generate and what are the cost they have incurred the rest of the money basically we call it profit.

But whenever we talk about the finance, how the particular company generate or maybe invest that particular money or how the particular company can generate the fonts to produce that product? So, either company can start the business with certain kind of resources already they have or they can borrow the money from the commercial banks or any other financial institutions or already you might have the idea that they can raise the money from the market in terms of equity or the stock from the public, they can generate the money from the public. So, therefore, the people who are invested the money in that particular stock which is issued by that particular company, they become the owner because they are the stakeholder of that particular company, they are the shareholder of that particular company; so, that is why they basically they become the owner.

So, they are entitled to get certain kind of share of the profit what the company basically generates. So, in this context what we can say the total finance of the financial capital in aggregate sense we use that is nothing, but whatever money the company have generated in terms of depth and in terms of the equity which is basically the owners fund. So, that combinedly basically talked takes care of the financing activities of the company and that particular financial capital is utilized for the investment in the future.

So, therefore, the money credit and capital these are the different terms which are mostly used in the finance literature or in the financial market to define certain issues. So, that is why we should know that how these particular things are different and how these particular things are used in the financial market by the different stakeholders.

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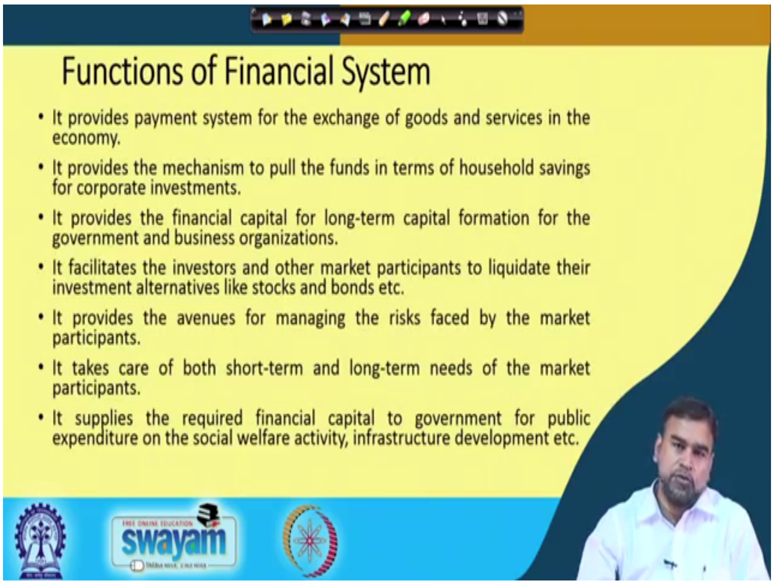

Then we can come to the, what exactly the financial system does, why we need a financial system. Already you have the idea the financial system is nothing, but it is a particular system which tries to aggregate try to integrate the all the stakeholders, who are trying to participate in the market with certain objectives like the maximization of the return or getting certain kind of loans or provide certain kind of loans. All kinds of stakeholders are basically getting certain kind of benefits from this particular system.

But in a very systematic sense, on in a very we can say that not in a layman prospective, but from a economics prospective and from a systematic way of understanding if you see that what are those functions of the financial system. Then if you see one by one first one basically it provides the payment system for exchange of goods and services in the economy.

You have already you already have the idea that any kind of exchange or any kind of transactions which takes place in the system that is true banks or any other financial institutions. Wherever you want to put your money, you put your money in the bank, you put your money in the stock market, you put your money any other market whatever stakeholder whatever markets we have what kind of stakeholder you are does not matter, but any medium of accents for any kind of exchange if you want to do, then you have to take the help of the financial system because financial system is only is helpful for kind of for exchanging the goods and services from one particular sector to another sector.

So, the all the payments are basically made through the banking if you take the example of India and also there are other financial institutions which help them for this payment mechanism. So, because of that it provides the kind of services which to exchange the goods and services in the economy at a large. Then another thing you see that if anybody wants to whatever income you have and whatever consumption you are making whatever money is surplus basically were keeping with you. If you are keeping with you at home it has no use.

So, financial system basically helps that if the money the surplus money of the household sector can go to the financial system and that money can be utilized in the market that money can be utilized by the another corporate who takes it as a loan, it can be taken as another individual for housing purpose, it can be taken as an individual for business purpose. So, therefore, it provides certain mechanism to pull the fonts in terms of the household savings for the corporate investments. Finally, in general sense we always call household sector are basically the savers household sector are the individual are the savers and the business are the corporate sectors are basically the investors.

So, once the money has been pulled out then that money can be utilized in the market by the corporate sector and it generates certain kind of revenue. Another thing also if you see, once we are making the small small savings somebody is could have 500, somebody could have 5000 does not matter, but end of the day whenever that particular money is accumulated in a bank or any other financial institutions which are existing in that particular system, then that particular money helps to create the long term capital formation for the government and the corporate sector or the business organization.

That money can go to the government, that money can go to the other private entities and they create certain kind of for capital formation in terms of the fixed assets. The money can be utilized to generate certain assets certain infrastructure, which can be further again utilized to generate profit a certain generate certain revenue for the business unit, which indirectly again helps the individuals or helps the aggregate economy to maximize or increase the growth rate in a larger way. So, therefore, it basically helps for the capital formation in that sense we can say.

And so, already you know that it also provides kind of infrastructure it provides certain platform or it facilitates the process by which the investors and other market participants can liquidate their investment alternatives like stocks and bonds. For example, somebody wants to invest in the stock how they can invest without the help of the financial system they cannot without the help of the financial market they can invest in the stock. If they want to sell the stock, then they want a infrastructure from the financial market also to sell the stock.

So, like that whether it is stock or born or any other gold in any other instruments nowadays you have for various financial alternatives which are available. So, those kind of assets or those kind of instruments can bought and sold through financial system only. So, therefore, it has lot of implications for generation of the resources in as well as provides the services in terms of the different instruments and finally, that services or that instruments can be liquidated to generate the cash at the time of requirements. So, therefore, what we can say it helps in that way that provides a very larger financial services to the system, which can are to the participants to liquidate whatever financial alternatives they are holding. It also provides because there are enough alternatives which are available or enough financial alternatives which are available.

So, they are able to or the market participants are able to minimize the risk because they can diversify the risk because they enough alternatives are available in the market. So, therefore, what we can say that it also helps for minimization of the risk because all of you know that if you are holding more assets in your portfolio, then the unsystematic risk can be minimized will more on elaborate or elaborately discuss about systemic on systemic our different type of risk, what the investors face or the market participants trades in the coming sessions.

But now we can say that if you are holding more assets or more type of assets in your portfolio then if one way in one case you are losing that is the possibility that the other asset can perform better then you make in. So, because of that it can say that it provides the avenues for managing the risk because all type of funds which are coming to the market and it does not have any kind of very biased kind of requirements or biased kind of term to maturity involves in that it catters the demand for both short term and long term needs of the market participants; somebody wants money for 3 months, somebody wants money for 5 years somebody wants money for 20 years.

So, the financial system is the only system who is able to cater the demand for all type of stakeholders on the different maturity. So, therefore, we can say it takes care of both short term and long term needs of the market participants. Already I have told you it provides the financial capital to the government for the public expenditure on the different infrastructure projects and that infrastructure projects in the future can generate excess revenue and also maximize the welfare of the people in the economy at a large.

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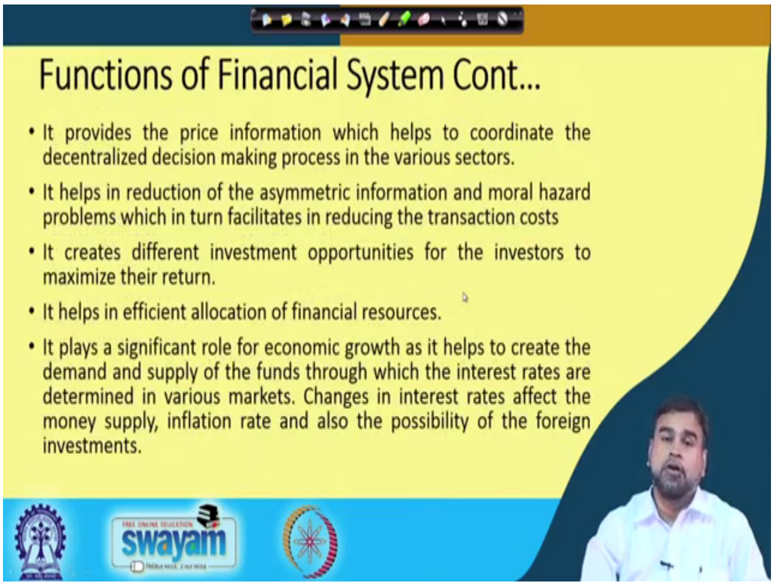

Another thing that if you see the market, financial market provides the price information at what price we should buy the particular stock, at what price we should the bond price would be issued and also it can give you a generate or it can generate an idea that whether whatever price am paying for some kind of asset whether it is the price is a fair price or not or whether the price is really price which is in equilibrium or not.

So, that basically can be always we can get it whenever we have a definite financial system and financial system is able to only provide that kind of information to us and it also helps in the reduction of a symmetric information and moral hazard problem which in turn facilitates in reducing the transaction cost. I will just little bit elaborate on this whenever we are investing in the market or we want to participate in the market always we should ensure the cost what we are bearing in the markets should be less.

But how the cost can be minimized? The cost can be minimized whenever you have all the informations. I can give an example if somebody is selling the car somebody is buying the car particularly the old car, then you will find the person who is basically selling the car this old car he has all the information about the car what the person who is buying the car they have less information. So, in that context what happens the buyer always says that they always feels that he should pay less, but the seller always feels that feels that I should get more.

So, then that particular thing creates certain kind of risky situation in the market because of there is a symmetric information and finally, what will happen that the price what they will get that price may not be actual fair price for this investor can or the particular buyer and seller can finally, decide upon. But if there is a system, which is there are so many participants are available and as well as the financial system can integrate all of them can bring them together then what will happen that finally, the price what basically will be decided that prices can be a fair price can be equilibrium price in the system at a large.

It creates the investment opportunities to maximize the return that is related to the portfolio part that already I have shared with you then, it also helps in efficient allocation of the resources because there are so, many stakeholders and it caters the demand for all the needs in that context whoever needs and whatever purpose the financial system is able to cater this demand for this particular investors or the market participants.

So, therefore, it plays a significant role for economic growth it creates a demand supply of the fonts and it also we can say that because the change in the demand and supply have the impact of on the interest rate in the market. Then it basically affects the total money supply inflation and the foreign investments all those details in general we will be discussing in a very elaborate way or elaborate manner in the upcoming sessions.

But this is the way the financial system basically helps this that is why we can say these are the major functions of the financial system.

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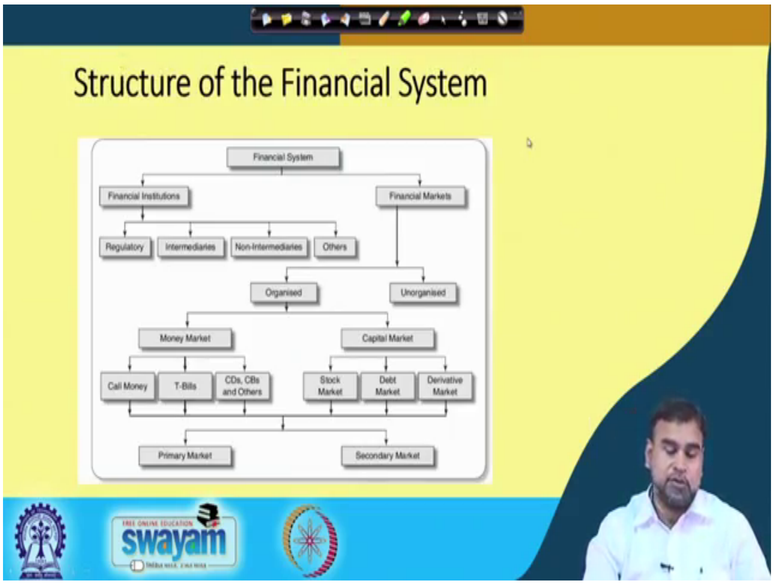

Then coming back to the structure of the financial system how exactly the financial system is and how it is defined if you see. In general the financial system is divided into two parts as already you know from that particular title of the course that we have financial institutions we have the financial markets.

And if you talk about the financial institutions there are different kind of institutions basically work in the system some institutions are regulatory like if you talk about India, we have Reserve Bank of India we have Security Design Security design exchange board of India, we have Pension Fund Regulatory Development Authority, we have IRDA that is Insurance Regulated Development Authority there is RBA regulates banks the semi regulates, the stock market and the pension funds are regulated by pfrda or pension funds redevelopment authority, then we have the idea which regulates the insurance companies and we have intermediaries and we have some non intermediaries. Intermediaries are basically the banks and others and who are those non intermediates we will discuss these things little bit in more elaborate in this session.

Then we have some other organizations; there are notable, there are specialized organizations which are also exist in the market and if you talk about this financial market there are two types of market; we have organized we have unorganized market, but this course mostly we will concentrate upon the organized market because unorganized markets are many where there is no formal kind of mechanism or a functional system operational system exists for them. So, because of that we will be more a little bit more focusing on the organized financial markets.

So, the organized financial markets again can be divided into two parts, one is your money market second one is the capital market and we have another segment we have the foreign market foreign exchange market. So, here the, if you talk about the money market there are different type of money markets. The markets are basically classified on the basis of the term to maturity or the instrument which are available.

Within the money market, we have call money market, we have treasury bills, we have certificate of deposits, commercial papers, etcetera and in terms of capital market where basically the long term securities are traded we have stock market, we have depth market, we have the derivatives market. Depth market means I am referring to the bond market then already I told there is another segment another market that is foreign exchange market. Then every market is has two segments, one is primary another one is secondary.

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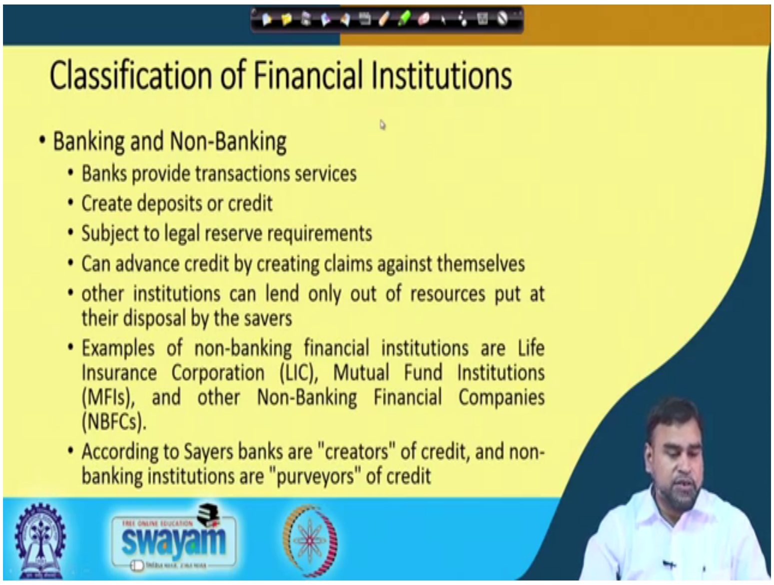

Then if you see that how you can classify the financial institutions? There is banking and non banking and why there is a difference because banks provide transaction services; it creates the deposit or the credit what are other financial institutions cannot do it subject to some reserve requirement like they have to fulfill certain requirements or regulations what is impose by RBI like they have to maintain the CRR, SLR and all kinds of thing that we will discuss further. And also they can give more loan whatever deposits they have because they can create the money.

And if you talk about the non banking institutions, we have like LIC, you have the mutual funds, you have the NBF says other non banking financial companies. So, these are basically takes the money from us, but they are not basically are able to create the money in the system. So, they are basically the user of the money or purveyors of the credit, but they are not the creator of the credit, but commercial banks are able to create the credit in the system. So, that is the way the classification can be made.

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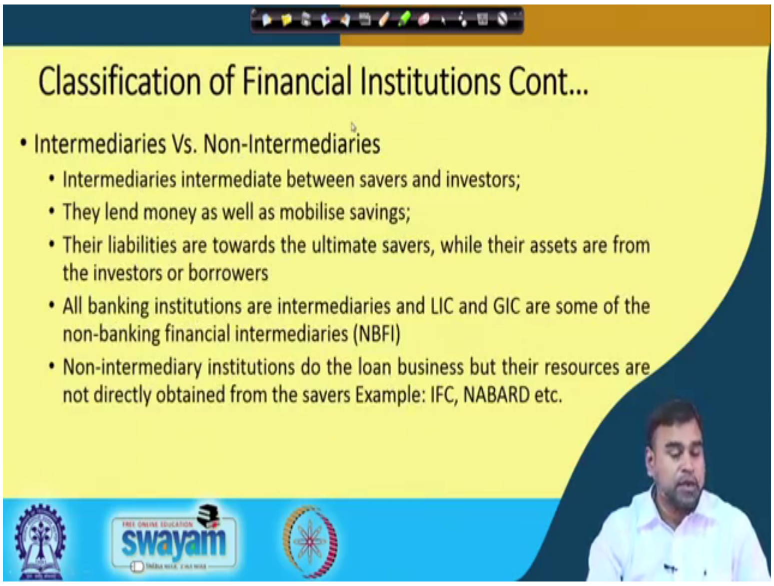

Other classification we can make in this way like intermediaries and non intermediaries. Intermediaries basically intermediate between the savers and the investors like we are the servers and the corporate sector are the investors, then they basically try to bring them together. They lend money and as well as mobilize the savings, their liabilities are towards the ultimate savers while their assets are from the investors or the borrowers. All banking institutions LIC, GIC they are basically a form of the financial intermediaries, but whenever you talk about the non intermediary although they do the loan business where the resources are not directly from the savers.

For example, if you talk about NABARD. NABARD organization who provide the services to the particular group of the people in the country and mostly the money comes from the other financial assistance from the government.

So, because of that we can say that they are basically this non intermediary because they do not directly interact with the savers or the investors. But whenever we talk about the banks or LIC they take the money directly from the individuals or the savers entire to utilize that money and also they provide the loan at the time of requirements.

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Then already I told you that we have two types of markets broadly one is money and capital market the conventional a distinction is basically based upon the maturity period. Almost all the financial market provides certain instruments certain services in detail we will discuss throughout this particular course.

But if you see the actual with formal definition the formal definition is the money market deals with the short term claims with a period of maturity one or less some people are you can go. Some people argue that the money market can deal with up to the maturity 3 years. Although this is a formal definition, but sometimes the maturity period can go up to 3 years and the capital market basically deals with the longer term maturity here we have given a definition that the period should be more than one year, but in some cases you can say that the period can more than 3 years also.

So, in aggregate I can say that the you can take the short term period up to 3years maturity and if the period of maturity is more than 3 years, then we can call them the long term market or there the instruments are basically traded in the capital market. So, that is the way this is defined and mostly this money market like call money market reserve wills market certificate of deposits market, commercial papers market. These are basically called as the money market money markets and the capital market stock market one corporate one market etcetera.

Then already I told you that every market has two segments, one is primary and secondary. The primary market basically deals with the new financial claims or new securities which are coming to the market; that means, this is the new addition to the system and how the securities are issued what is the process of issuing that security and all these things that we will discuss in detail. And the secondary market means one the market in the primary market the money comes or the particular securities comes to the system then depending upon the demand and supply it basically always traded in the market and depending upon the demand and supply the price basically fluctuates for that security.

So, these are basically we call them the instruments of the secondary market. For example, somebody first time is issue the share we call it they are the IPOS and initial public offerings and once it is listed in the stock exchange traded in the market, we call them they are the instruments of the secondary market. That is why the secondary market deals with already this already suit or existing or securities which are there and the price fluctuation happens because of the demand and supply of the security in that particular system.

So, overall I have given you this idea that what this financial system is then how the financial system is helpful for the economic growth process and which are the different major kind of financial institutions and the financial market exists in the system and how the structure looks like and then in the following session will be discussing about how the equilibrium in the financial market is established and what do mean by the equilibrium in the financial system and as well as in general how the particular concept is helpful for this.

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Please go through these particular references for this particular session.

Thank you very much.