

Financial System – Overview, Functions, Components and Classification

1. Overview of Financial System

Meaning of Financial System

A Financial System is a network of institutions, markets, instruments, and services that help in the movement of money from people who have surplus funds to those who need funds. It plays a vital role in the economic development of a country. It helps individuals, businesses, and governments to save, invest, borrow, and manage money efficiently. A well-developed financial system promotes economic growth and financial stability.

Example: A person deposits money in a bank, and the bank lends that money to a business for expansion.

2. Functions of Financial System

1. Mobilization of Savings

The financial system encourages people to save their excess money through banks, post offices, mutual funds, and other financial institutions. These savings are collected and made available for productive purposes. This helps in increasing investment and economic growth.

Example: Depositing money in a savings account with a bank.

2. Allocation of Funds

The financial system transfers funds from savers to individuals, businesses, and governments who need money for productive activities. This ensures that resources are used efficiently. Proper allocation helps industries and businesses grow.

Example: A bank providing a business loan to a manufacturing company.

3. Facilitates Investment

The financial system provides various investment opportunities such as shares, bonds, mutual funds, and fixed deposits. Investors can choose options according to their risk and return preferences. This helps in wealth creation.

Example: Investing in a mutual fund SIP.

4. Provides Liquidity

Liquidity means converting an asset into cash quickly without significant loss in value. Financial markets and institutions make it easier for investors to access their money whenever required. This increases confidence among investors.

Example: Selling shares on the stock exchange and receiving money.

5. Risk Management

The financial system offers instruments and services to reduce financial risks. Insurance companies and diversification options help individuals and businesses protect themselves from uncertainties. This promotes financial security.

Example: Purchasing a life insurance policy.

6. Facilitates Payments and Settlements

The financial system provides payment mechanisms for smooth transfer of money. Digital banking, UPI, cheques, and debit cards make transactions easy and secure. This improves business and personal financial activities.

Example: Making a payment through UPI.

7. Supports Economic Growth

By channelizing savings into productive investments, the financial system promotes industrial and economic development. It creates employment opportunities and improves living standards. A strong financial system is essential for a nation's progress.

Example: Banks financing infrastructure projects such as highways and airports.

3. Components of Financial System

1. Financial Institutions

Financial institutions are organizations that provide financial services such as accepting deposits, granting loans, investing funds, and offering insurance. They act as intermediaries between savers and borrowers. These institutions ensure efficient flow of funds in the economy.

Example: State Bank of India

Types:

- Banking Institutions (Commercial Banks, Cooperative Banks)
- Non-Banking Financial Companies (NBFCs)
- Insurance Companies
- Mutual Fund Companies

2. Financial Markets

Financial markets are places where buyers and sellers trade financial assets such as shares, bonds, and currencies. These markets facilitate the transfer of funds and help determine prices of financial instruments. They provide liquidity and investment opportunities.

Example: National Stock Exchange

Types:

- Money Market
- Capital Market
- Foreign Exchange Market
- Derivatives Market

3. Financial Instruments

Financial instruments are documents or contracts that represent a financial claim or ownership. They are used for investment, borrowing, and lending purposes. Investors choose instruments based on their financial goals and risk appetite.

Example: Shares of a company.

Examples:

- Shares
- Debentures
- Bonds
- Treasury Bills
- Mutual Fund Units

4. Financial Services

Financial services refer to services provided by financial institutions to help customers manage money effectively. These services facilitate savings, investments, insurance, and financial planning. They improve financial convenience and accessibility.

Example: Home loan services offered by a bank.

Examples:

- Banking Services
- Insurance Services
- Investment Advisory Services
- Credit Card Services
- Mutual Fund Services

4. Classification of Financial System
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A. On the Basis of Maturity of Funds**1. Money Market**

The money market deals with short-term funds and financial instruments having a maturity period of up to one year. It provides liquidity and meets short-term financial requirements of businesses and financial institutions. It is generally considered low-risk.

Example: Treasury Bills (T-Bills).

2. Capital Market

The capital market deals with long-term funds and securities with maturity exceeding one year. It helps companies and governments raise capital for long-term projects. Investors can earn returns through capital appreciation and dividends.

Example: Equity shares listed on stock exchanges.

B. On the Basis of Financial Institutions**1. Banking Institutions**

These institutions accept deposits from the public and provide loans and other banking services. They play a crucial role in money creation and credit distribution. Banks are highly regulated to ensure safety of public funds.

Example: Bank of Baroda

2. Non-Banking Financial Institutions (NBFI)

These institutions provide financial services but generally do not accept demand deposits like banks. They support lending, investment, insurance, and other specialized financial activities. They complement the banking sector.

Example: Bajaj Finance Limited

C. On the Basis of Financial Claims

1. Debt Market

The debt market deals with fixed-income securities where borrowers promise to repay the principal amount along with interest. It is suitable for investors seeking stable returns. Risk is generally lower than equity investments.

Example: Government Bonds.

2. Equity Market

The equity market deals with ownership securities known as shares. Investors become part owners of a company and may earn dividends and capital gains. Returns can be higher but involve greater risk.

Example: Shares of a listed company traded on a stock exchange.

Quick Revision

Topic	Meaning
Financial System	Mechanism for transfer of funds from savers to borrowers
Functions	Savings, investment, liquidity, risk management, payment system
Components	Financial Institutions, Markets, Instruments, Services
Money Market	Short-term funds (up to 1 year)
Capital Market	Long-term funds (more than 1 year)
Debt Market	Fixed-income securities
Equity Market	Ownership securities (shares)

One-Line Definition:

A Financial System is a network of institutions, markets, instruments, and services that facilitates the flow of funds from savers to borrowers and supports economic development.

Financial Market – Concept, Classification, Structure, Participants, Capital Market, Money Market and Foreign Exchange Market

1. Concept of Financial Market

Meaning of Financial Market

A financial market is a marketplace where financial assets such as shares, bonds, currencies, and other securities are bought and sold. It acts as a link between people who have surplus funds (savers) and those who need funds (borrowers). Financial markets help in the efficient allocation of resources and contribute to economic development. They provide liquidity, investment opportunities, and price determination for financial assets.

Example: An investor purchasing shares of a company through a stock exchange.

2. Classification of Financial Markets

A. Money Market

The money market deals with short-term financial instruments having a maturity period of up to one year. It helps businesses, banks, and governments meet their short-term financial requirements. The money market is highly liquid and relatively low-risk. It plays an important role in maintaining liquidity in the economy.

Example: Treasury Bills (T-Bills).

B. Capital Market

The capital market deals with long-term funds and securities having a maturity period of more than one year. It helps companies and governments raise funds for expansion, infrastructure, and development projects. Investors can earn returns through dividends, interest, and capital appreciation. Capital markets encourage savings and investment.

Example: Buying shares of a company through a stock exchange.

C. Foreign Exchange Market

The foreign exchange market (Forex Market) is a market where different currencies are bought and sold. It facilitates international trade, investment, and tourism. Exchange rates are determined by demand and supply of currencies. It is the largest financial market in the world.

Example: Converting Indian Rupees (INR) into US Dollars (USD) for foreign travel.

D. Derivatives Market

The derivatives market deals with financial contracts whose value depends on an underlying asset such as stocks, currencies, commodities, or interest rates. These instruments are mainly used for hedging risk and speculation. Derivatives help investors protect themselves against price fluctuations.

Example: Futures contract on a stock index.

3. Structure of Financial Market

The financial market consists of various institutions, intermediaries, instruments, and investors that facilitate the flow of funds within the economy. It can be broadly divided into Money Market and Capital Market.

Structure of Financial Market

Financial Market

- Money Market
 - Treasury Bills

- Commercial Papers
- Certificates of Deposit
- Call Money Market
- Capital Market
 - Primary Market
 - Secondary Market
 - Equity Market
 - Debt Market
- Foreign Exchange Market
 - Spot Market
 - Forward Market

Example: A company raises funds through the primary market and its shares are later traded in the secondary market.

4. Participants in Financial Market

1. Investors

Investors are individuals or institutions that invest money to earn returns. They provide funds by purchasing securities such as shares, bonds, and mutual fund units. Investors may be risk-averse or risk-taking depending on their financial goals.

Example: A person investing in shares of a listed company.

2. Borrowers or Issuers

Borrowers are entities that require funds for business operations, expansion, or development projects. They raise funds by issuing shares, bonds, or debentures. These entities include companies and governments.

Example: A company issuing shares through an Initial Public Offering (IPO).

3. Financial Institutions

Financial institutions act as intermediaries between savers and borrowers. They mobilize savings and provide loans, investment, and advisory services. These institutions ensure smooth functioning of financial markets.

Example: Commercial banks and mutual fund companies.

4. Brokers and Dealers

Brokers facilitate the buying and selling of securities on behalf of investors. Dealers trade securities in their own name and account. They help increase market efficiency and liquidity.

Example: A stockbroker executing share transactions for clients.

5. Regulators

Regulators supervise and regulate financial markets to ensure transparency, fairness, and investor protection. They formulate rules and monitor market activities. Their objective is to maintain market integrity.

Example: Securities and Exchange Board of India (SEBI).

5. Capital Market

Meaning

The capital market is a market for long-term funds and securities with a maturity period exceeding one year. It helps companies and governments raise capital for long-term projects. It promotes economic growth by encouraging investment and capital formation.

Example: A company issuing shares to finance a new manufacturing plant.

Features of Capital Market

1. Long-Term Financing

Capital markets provide funds for long-term business and development activities. These funds are used for expansion, modernization, and infrastructure projects.

Example: Raising funds for constructing a new factory.

2. Capital Formation

Capital markets mobilize savings and convert them into productive investments. This contributes to economic growth and employment generation.

Example: Public investment in corporate shares.

3. Investment Opportunities

Investors can invest in various securities according to their risk and return preferences. This helps in wealth creation.

Example: Investment in equity shares and bonds.

Components of Capital Market

A. Primary Market

The primary market is where new securities are issued for the first time. Companies raise fresh capital directly from investors.

Example: Initial Public Offering (IPO).

B. Secondary Market

The secondary market is where existing securities are traded among investors. No fresh funds are received by the issuing company.

Example: Trading shares on a stock exchange.

6. Money Market

Meaning

The money market is a market for short-term funds and financial instruments with a maturity period of up to one year. It helps manage liquidity and short-term borrowing needs. It is considered relatively safe and highly liquid.

Example: Treasury Bills issued by the Government of India.

Features of Money Market

1. Short-Term Transactions

The money market deals only in short-term funds. Maturity periods generally range from one day to one year.

Example: Commercial Paper with six months maturity.

2. High Liquidity

Money market instruments can be easily converted into cash. This makes them suitable for managing short-term cash requirements.

Example: Treasury Bills.

3. Low Risk

Most money market instruments are issued by governments, banks, or highly rated companies. Therefore, they carry lower risk.

Example: Certificate of Deposit issued by a bank.

Instruments of Money Market

1. Treasury Bills (T-Bills)

Short-term government securities issued to meet temporary financial needs.

Example: 91-day Treasury Bill.

2. Commercial Paper (CP)

Unsecured short-term debt issued by large companies.

Example: Commercial Paper issued by a reputed company.

3. Certificate of Deposit (CD)

Negotiable certificate issued by banks against deposits.

Example: Fixed-term Certificate of Deposit.

4. Call Money

Very short-term borrowing and lending among banks.

Example: One-day interbank loan.

7. Foreign Exchange Market (Forex Market)

Meaning

The Foreign Exchange Market is a market where different national currencies are bought and sold. It facilitates international trade, foreign investment, tourism, and remittances. Exchange rates are determined by market demand and supply.

Example: Exchanging Indian Rupees for US Dollars before travelling to the USA.

Functions of Foreign Exchange Market

1. Currency Conversion

It enables conversion of one currency into another for international transactions.

Example: Converting INR into Euro for studying abroad.

2. Facilitates International Trade

Importers and exporters require foreign currencies to settle international transactions. The forex market provides this facility.

Example: An Indian importer paying a US supplier in dollars.

3. Hedging Exchange Risk

Businesses can protect themselves against fluctuations in exchange rates using forex instruments.

Example: Using forward contracts to lock in exchange rates.

4. Transfer of Purchasing Power

It allows transfer of funds across countries for trade, investment, and personal remittances.

Example: NRIs sending money to family members in India.

Quick Revision Table

Market	Meaning	Example
Money Market	Deals in short-term funds (up to 1 year)	Treasury Bills
Capital Market	Deals in long-term funds (more than 1 year)	Shares, Bonds
Foreign Exchange Market	Deals in buying and selling of currencies	INR to USD conversion
Primary Market	New issue of securities	IPO
Secondary Market	Trading of existing securities	Stock Exchange Trading

One-Line Definition

A Financial Market is a mechanism through which financial assets and funds are exchanged between savers and borrowers, facilitating investment, liquidity, and economic growth.