

Management of Financial Services

By: Taruna Jain

This reference book can be useful for
BBA, MBA, B.Com, BMS, M.Com, BCA, MCA
and many more courses for Various Universities



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Sample Preview of The Chapter

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MANAGEMENT OF FINANCIAL SERVICES

FINANCIAL SYSTEM, MARKETS AND SERVICES



Financial System

INTRODUCTION

This chapter introduces us to the concept of financial system and financial market. Financial system can be defined as a set of complex and closely connected or intermixed agents, practices, markets, transactions, etc in the economy. In the economy and the related areas, financial system plays a vital role. The major components of financial system are financial institutions, financial markets, financial instruments and financial services.

- Financial institutions are the institutions which mobilize and transfer the savings or funds from the surplus units to deficit units.
- The place from where the funds are transferred from the surplus units to deficit units are called as financial markets
- The commodities that are traded in the financial markets are called as financial instruments
- Financial services are the services offered by the Asset management companies and Liability Management companies.

Financial markets play a crucial role in the economic functions and are classified as:

- Primary and secondary markets
- Money and capital markets

The security markets play a vital role in controlling the free flow of the funds from the surplus to deficit units and also provide liquidity in the market. There are many factors that have led to the integration of the financial markets and it includes:

- Deregulation or liberalization of markets
- Technological advancements
- Increase in institutionalisation of financial markets

Global financial markets are classified as external and internal markets. Internal markets are also called as domestic markets and external markets are called as international markets.

CHAPTER AT A GLANCE

FINANCIAL SYSTEM

In finance, the financial system is the system that allows the transfer of money between savers (and investors) and borrowers. A financial system can operate on a global, regional or firm specific level. In financial system, system refers to a set of complex and closely connected or intermixed instructions, agents, practices, markets, transactions, claims and liability in the economy.

The four basic components of Financial System are:

1. Financial Institutions.
2. Financial Markets.
3. Financial Instruments.
4. Financial Services.

(1) Financial Institutions: In financial economics, a financial institution is an institution that provides financial services for its clients or members. Probably the most important financial service provided by financial institutions is acting as financial intermediaries. Most financial institutions are regulated by the government.

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Broadly speaking, there are three major types of financial institutions:

1. Depository Institutions
2. Contractual Institutions
3. Investment Institutions

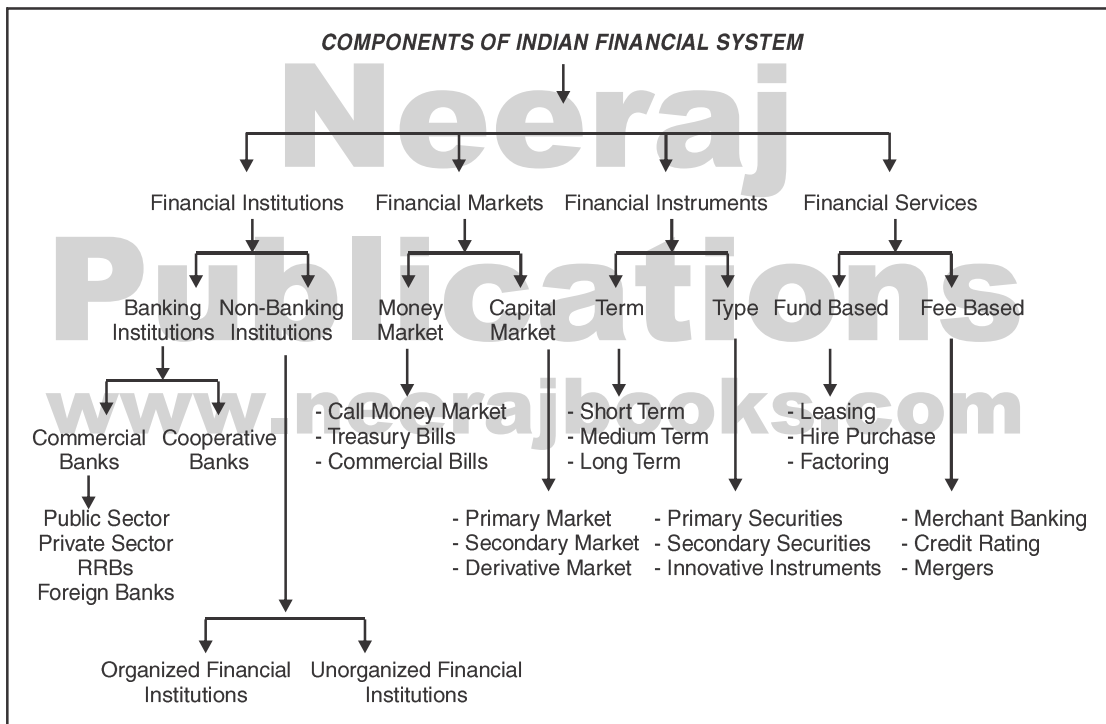
(2) Financial Markets: A financial market is a market in which people and entities can trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural goods.

There are both general markets (where many commodities are traded) and specialized markets (where only one commodity is traded). Markets work by placing many interested buyers and sellers, including households, firms, and government agencies, in one “place”, thus making it easier for them to find each other. An economy which relies primarily on interactions

between buyers and sellers to allocate resources is known as a market economy in contrast either to a command economy or to a non-market economy such as a gift economy.

(3) Financial Instruments: A financial instrument is a tradable asset of any kind, either cash; evidence of an ownership interest in an entity; or a contractual right to receive, or deliver, cash or another financial instrument.

(4) Financial Services: Financial services are the economic services provided by the finance industry, which encompasses a broad range of organizations that manage money, including credit unions, banks, credit card companies, insurance companies, consumer finance companies, stock brokerages, investment funds and some government sponsored enterprises. As of 2004, the financial services industry represented 20% of the market capitalization of the S & P 500 in the United States.



FINANCIAL MARKETS : AN INTRODUCTION

Broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives. Financial markets are typically defined by having transparent pricing, basic regulations on trading, costs and fees and market forces determining the prices of securities that trade.

Some financial markets only allow participants that meet certain criteria, which can be based on factors like the amount of money held, the investor’s geographical location, knowledge of the markets or the profession of the participant.

In finance, financial markets facilitate:

- The raising of capital (in the capital markets).
- The transfer of risk (in the derivatives markets).

- Price discovery.
- Global transactions with integration of financial markets.
- The transfer of liquidity (in the money markets).
- International trade (in the currency markets).

Typically, a borrower issues a receipt to the lender promising to pay back the capital. These receipts are securities which may be freely bought or sold. In return for lending money to the borrower, the lender will expect some compensation in the form of interest or dividends. This return on investment is a necessary part of markets to ensure that funds are supplied to them.

ROLE OF FINANCIAL MARKETS

The states need fund for their growth and development which is obtained either from an individual or business firms of public sector unit or from Central, State or Local Government, etc. The financial system play a vital role in transferring the surplus from savers to borrowers. This process is known as transmission mechanism.

The flow of fund is important for achieving the desired goals which should be in right direction and for productive purposes. The financial market should be efficient enough to manage the flow of funds in the economy. Also the financial market should work towards motivating the individuals and the institutions to save more. In the financial market the flow of fund is either directly through financial market or indirectly through financial institutions.

Some more important contributions of the financial market includes:

- Helping in the fast growth of the industry and economy.
- Contributing towards societies well being and improving their standard of living.
- Allocation of economy's savings in efficient production of goods and services to achieve the desired national objective.

FUNCTIONS OF FINANCIAL MARKETS

(a) Economic Functions

- **Borrowing and Lending:** Financial market transfers fund from one economic agent (saver/lender) to another (borrower) for the purpose of either consumption or investment.
- **Determination of Prices:** Prices of the new assets as well as the existing stocks of financial assets are set in financial markets.
- **Assimilation and Co-ordination of Information:** It gathers and co-ordinates information regarding the value of financial assets and flow of funds in the economy.

- **Liquidity:** The asset holders can sell or liquidate their assets in financial market.
- **Risk Sharing:** It distributes the risk associated in any transaction among several participants in an enterprise.
- **Efficiency:** It reduces the cost of transaction and acquiring information.

(b) Financial Functions

- Providing the borrower with funds so as to enable them to carry out their investment plans.
- Providing the lenders with earning assets so as to enable them to earn wealth by deploying the assets in production debentures.
- Providing liquidity in the market so as to facilitate trading of funds.

In addition to the above mentioned functions, the financial market perform some other intermediary functions which are as follows:

Intermediary Functions: The intermediary functions of financial markets include the following:

Transfer of Resources: Financial market facilitate the transfer of real economic resources from lenders to ultimate borrowers.

Enhancing Income: Financial markets allow lenders to earn interest or dividend on their surplus invisible funds, thus contributing to the enhancement of the individual and the national income.

Productive usage: Financial market allow for the productive use of the funds borrowed. The enhancing the income and the gross national production.

Capital Formation: Financial market provides a channel through which new savings flow to aid capital formation of a country.

Price determination: Financial markets allow for the determination of price of the traded financial assets through the interaction of buyers and sellers. They provide a sign for the allocation of funds in the economy based on the demand and supply through the mechanism called price discovery process.

Sale Mechanism: Financial markers provide a mechanism for selling of a financial asset by an investor so as to offer the benefit of marketability and liquidity of such assets.

Price determinants: Financial market allow for the determination of price of the traded financial asset through the interaction of buyers and sellers. They provide a signal for the allocation of funds in the economy, based on the demand and supply through the mechanism called price discovery process.

Sale mechanism: Financial markets provide a mechanism for selling of a financial asset by an investor so as to offer the benefits of marketability and liquidity, of such assets.

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Information: The activities of the participants in the financial market result in the generation and the consequent dissemination of information to the various segments of the market. So as to reduce the cost of transaction of financial assets.

CLASSIFICATION OF FINANCIAL MARKETS

Within the financial sector, the term “financial markets” is often used to refer just to the markets that are used to raise finance: for long term finance, the Capital markets; for short term finance, the Money markets. Another common use of the term is as a catch all for all the markets in the financial sector, as per examples in the breakdown below.

Capital markets which consist of:

- Stock markets, which provide financing through the issuance of shares or common stock, and enable the subsequent trading thereof.
- Bond markets, which provide financing through the issuance of bonds, and enable the subsequent trading thereof.

Money markets provide short term debt financing and investment.

The capital markets and money market may also be divided into primary markets and secondary markets.

1. Primary and Secondary Markets

Newly formed (issued) securities are bought or sold in primary markets, such as during initial public offerings.

Secondary markets allow investors to buy and sell existing securities. The transactions in primary markets exist between issuers and investors, while in secondary market transactions exist among investors.

2. Money and Capital Markets

According to the period of maturity of the financial assets with which the markets are dealing, the markets can be classified as:

- Money Market.
- Capital Market.

These markets are again classified as primary markets and secondary markets.

Money market deals with instruments having a period of maturity of one year or less like treasury bills, bills of exchange etc. Capital market deals with all instruments having a period of maturity of above one year like corporate debentures, government bonds, equity and preference shares etc.

Money Market: Money market deals in short-term debt, and channel the savings into short-term productive investments like working capital, call money, treasury bills etc.

In India, money market is classified into the organized segment and unorganized segment. The

organized segment is characterized by fairly rigid and complex rules and is dominated by commercial banks and major financial institutions like UTI. This segment is subjected to tight control by the Reserve Bank of India. Unorganized segment is characterized by informal procedures; flexible terms and attractive rates of interest both depositors and borrowers. The unorganized sector is dominated by money lenders.

Capital Market: Capital market is the market for financial assets having a period of maturity of more than one year or of an indefinite period. Thus, capital market provides long-term resources needed by medium and large scale industries.

The Indian capital market which had been lying dormant in the seventies up to mid-eighties has witnessed an unprecedented boom and undergone sea change with a number of financial services and banking companies, merchant bankers, more stock exchanges, ventures capital funds, private sector mutual funds, foreign institutional investors, over-the-counter exchange, national stock exchange, credit rating services, custodial services, portfolio management services, non-resident investment, new regulations etc. emerging on the Indian capital scene.

Comparison of Money Market and Capital Market:

Both money market and capital market are different. Following are some of the differences:

- Money market exist as a means of liquidity adjustments and capital market serve as a link between long term borrowers and long term investors.
- In terms of risks money market generally carry low risks whereas capital market carry higher risks.
- Money market is dominated by one set of financial institutions whereas no single institution dominate the capital market.
- The money market instruments are short term in nature whereas the capital market instruments are comparatively long.

As far as transferring of resources is concerned both money market and capital market is same as both perform the same function of transferring resources from the economic surplus units to deficit units. The flow of fund is substantial between the money and the capital market because the lenders and the borrowers of the funds have to access both the money and the capital market.

INDIAN MONEY AND CAPITAL MARKETS

(a) Indian Money Market

The Indian money market is “A market for short-term and Long term funds with maturity ranging from