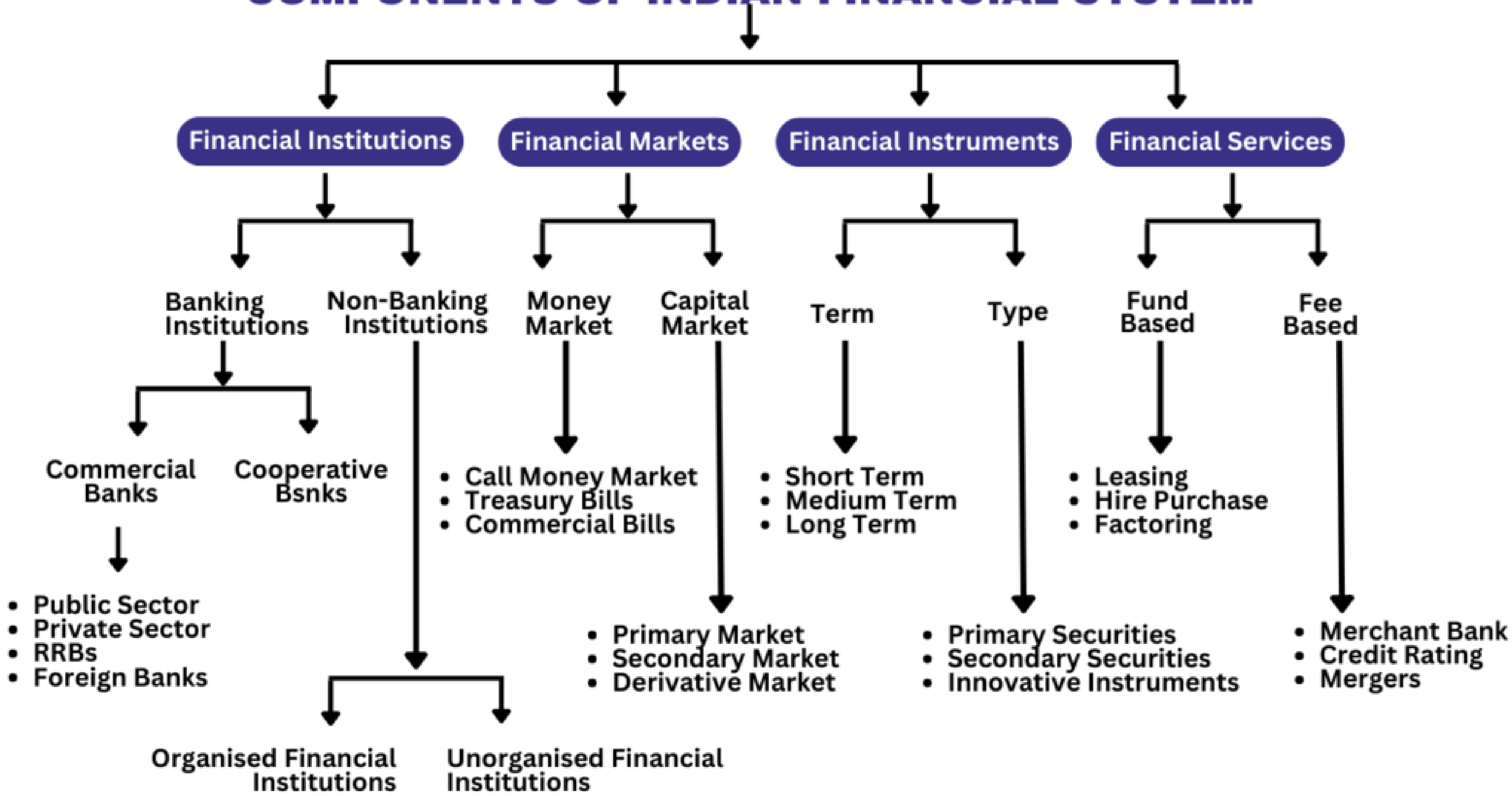
Structure of Financial System

Introduction

The financial system is the backbone of an economy, enabling resource allocation, risk management, and economic growth.

The financial system is a network of institutions, markets, instruments, and services that facilitate the flow of funds between savers and borrowers. It plays a vital role in mobilizing resources and supporting economic development.

COMPONENTS OF INDIAN FINANCIAL SYSTEM



Functions of Financial System

Provision of liquidity

Mobilization of savings

Size transformation function

Maturity transformation function

Risk transformation function

Role of Financial System in Economic Development

Mobilization of Savings

Efficient Allocation of Resources

Promotes Investment

Encourages Innovation and Entrepreneurship

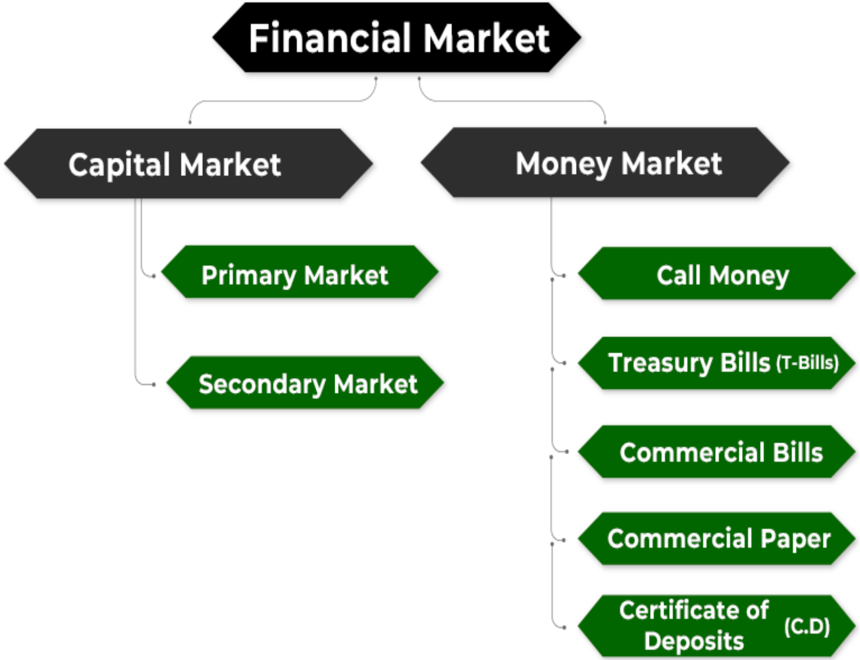
Employment Generation

Supports Government Policies

Global Integration

Stability and Growth

Financial Markets and Financial Instruments



Capital Market

Including all institutions, organisations, and instruments providing medium and long-term funds is known as a Capital Market

Instruments

- Equity
  - Common
  - Preference
- Debt Instruments
  - Bonds
  - Debentures
- Derivative Instruments
- Exchange Traded Funds
- Foreign Exchange Instruments

Stock Market

Virtual or physical marketplace where sellers and buyers trade in securities.

Primary and secondary

Stock market vs stock exchange

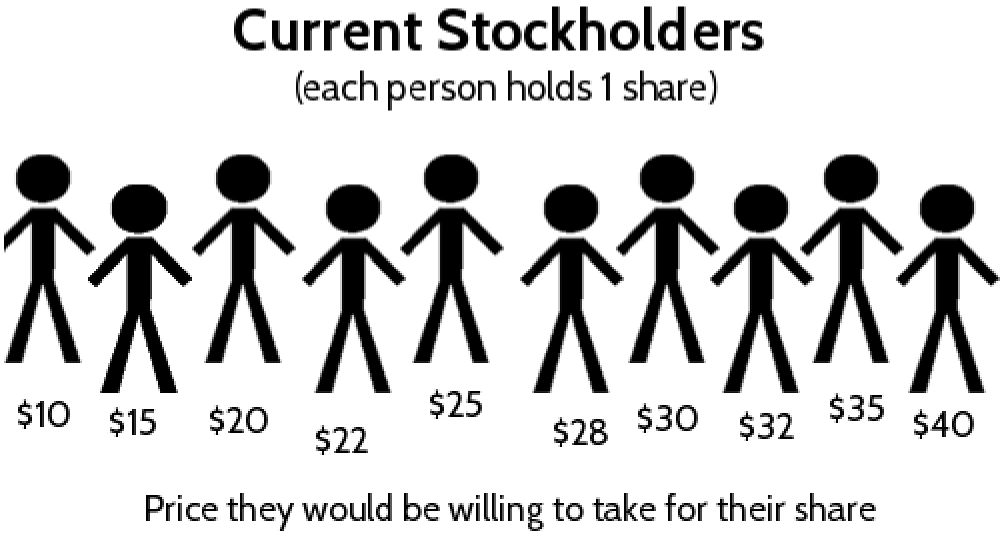
The price of a stock changes based on the demand for shares from new investors who want to buy, or the supply of shares from existing investors who want to sell.

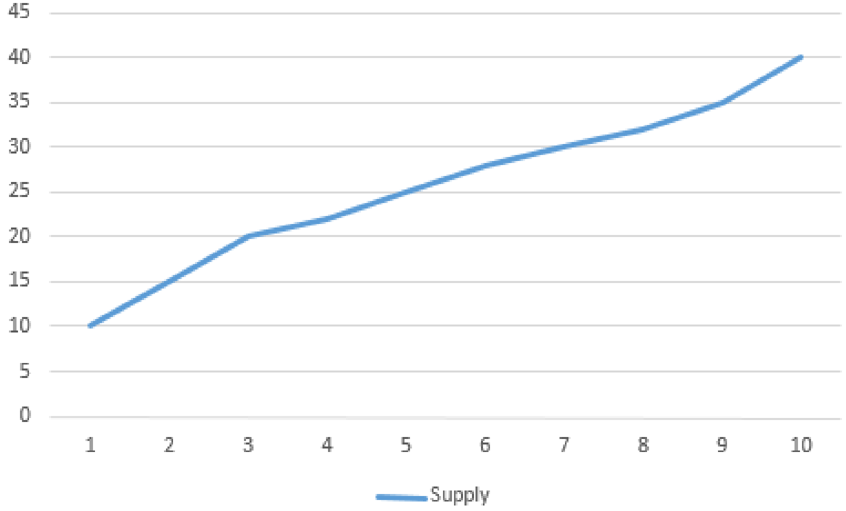
A market in which the securities are sold for the first time is known as a **Primary Market.** It means that under the primary market, new securities are issued from the company. Another name for the primary market is **New Issue Market.** This market contributes directly to the capital formation of a company, as the company directly goes to investors and uses the funds for investment in machines, land, building, equipment, etc.

A market in which the sale and purchase of newly issued securities and second-hand securities are made is known as a **Secondary Market.** In this market, a company does not directly issue its securities to the investors. Instead, the existing investors of the company sell the securities to other investors. The investor who wants to sell the securities and the one who wants to purchase meet each other in the secondary market, and exchange the securities for cash takes place with the help of an intermediary called a **broker.**

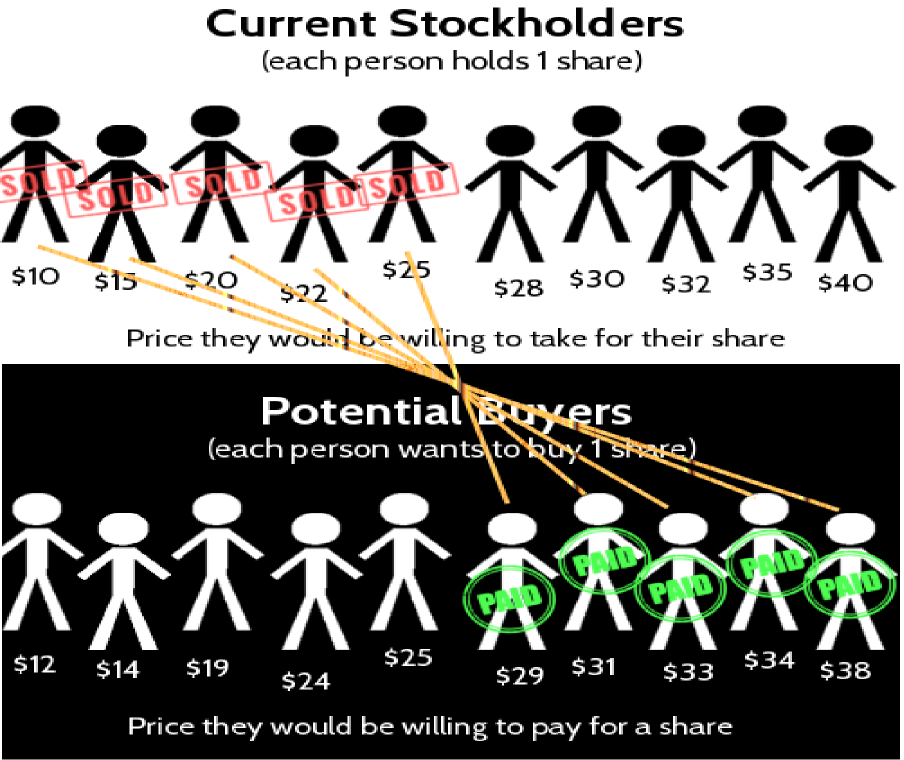
- IPO
- Private placement
- Right issue
- Bonus issue

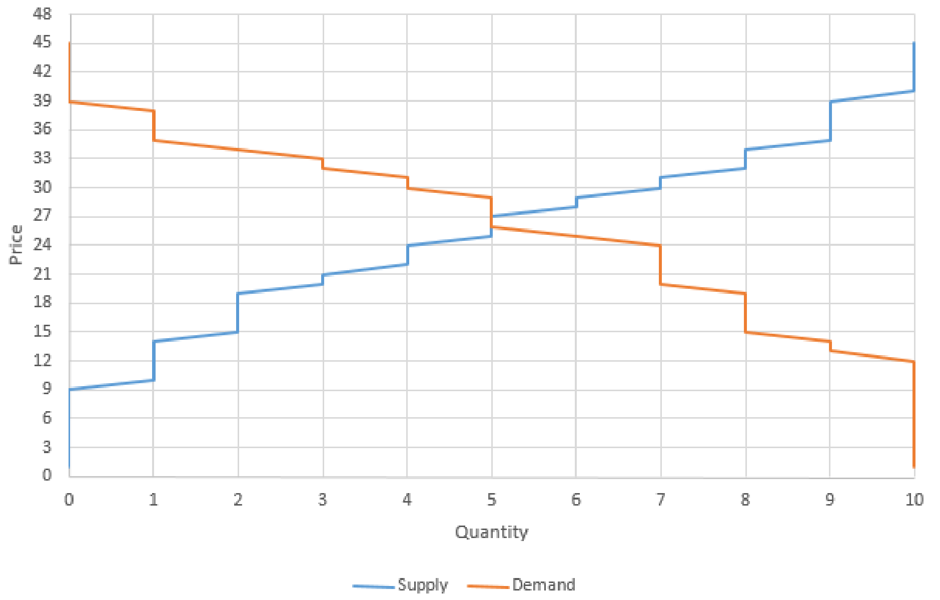
Supply of stocks



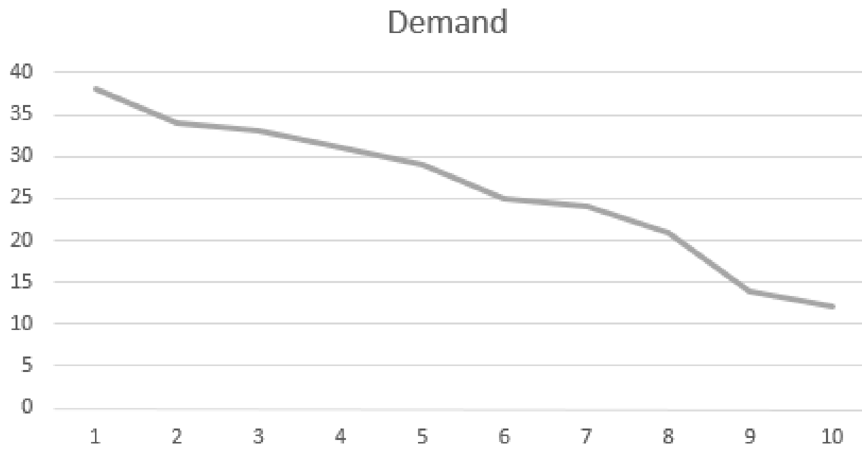


Market equilibrium





Demand for stocks



Surplus

Consumer Surplus = Highest Price a buyer is willing to pay – Price they actually pay

Producer Surplus = Price a seller actually sells an item for – Lowest price they would sell for

Total Surplus = Consumer Surplus + Producer Surplus

Bond Market

A bond market is a marketplace for debt securities.

Fixed income security

Primary and secondary

Defaulting on a bond is a significant matter that usually results in a company's insolvency.

As a result, corporations prioritize making timely bond payments.

Types of Bonds

Government Bonds- T Bill

Corporate Bond

Municipal Bond etc

Money Market

A market for short-term funds that are meant to use for a period of up to one year is known as **Money Market.**

In the general case, the money market is the source of funds or finance for working capital. The transactions held in the money market involve lending and borrowing of cash for a short term and also consist of the sale and purchase of securities with one year term or securities which get paid back (redeemed) within one year.

- Call Money
- Commercial Bills
- T. Bills
- Commercial Paper
- Certificates of Deposits
- Repurchase Agreement etc

Mortgage Market

The mortgage market is the business of lending money to buy houses and other properties. It is made up of two parts: the primary mortgage market and the secondary mortgage market.

The primary mortgage market is where borrowers can get a mortgage loan from a primary lender

The secondary mortgage market is where mortgage investors buy mortgages

Mortgage Backed Securities

Mortgage-backed securities (MBS) are investments like bonds. Each MBS is a share in of a bundle of home loans and other real estate debt bought from the banks or government entities that issued them. Investors in mortgage-backed securities receive periodic payments like bond coupon payments.

MBS are asset-backed securities formed by pooling together mortgages. The investor who buys a mortgage-backed security is essentially lending money to homebuyers. An MBS can be bought and sold through a broker. The minimum investment varies between issuers.

How Mortgage-Backed Securities Work

The best way to understand MBS is to see how they are formed in the first place. Let's walk you through the steps:

- **Origination**: A financial institution, such as a bank, provides mortgages to homebuyers. These loans are secured by the properties being bought.
- **Pooling**: The bank and other institutions pool many of these mortgage loans. The loans in the pool typically have similar characteristics, such as interest rates and maturity dates.
- **Securitization**: The pooled mortgages are sold to a trust,, a government agency, or a private financial institution. The trust then structures these loans into MBS.
- **Issuance**: The MBS are issued and sold to investors. The securities are backed by mortgage loans in the pool. In the case of agency MBS, they are further guaranteed by the government agency, providing additional security to investors.
- **Servicing**: A mortgage servicer collects monthly mortgage payments from borrowers and distributes these payments to MBS investors.
- **Investment**: Investors buy MBS, effectively lending money to homebuyers in the pool. In return, they receive periodic payments, including interest and principal repayments from the underlying mortgages.

Derivative Securities Market

A financial marketplace where derivative contracts are bought and sold.

Derivatives are financial instruments whose value is derived from an underlying asset or a group of assets

These assets range from stocks, bonds, commodities, currencies, interest rates, or market indices

Forwards

Forward contracts are derivatives that involve an agreement between two parties to buy or sell an asset at a specified price (the forward price) on a future date. Participants use forward contracts to hedge against future price fluctuations of assets, thereby managing risk. Speculators may participate through forward contracts based on their beliefs about future asset prices, aiming to profit from price movements.

Futures

Futures are contracts that obligate the parties involved to buy or sell an asset at a predetermined price on a future date. Futures contracts are traded on various underlying assets like stocks, indices, commodities, and currencies.

Stock Futures: Future contracts based on individual stocks allow investors to speculate on the future price movements of specific companies listed on Indian stock exchanges like the NSE (National Stock Exchange) and BSE (Bombay Stock Exchange).

Index Futures: Future contracts based on market indices such as the Nifty 50 or Sensex. Traders use these to speculate on the broader market movement rather than specific stocks.

Commodity Futures: Futures contracts are also available for commodities like gold, silver, crude oil, agricultural products, etc. These contracts are traded on commodity exchanges like MCX (Multi Commodity Exchange) and NCDEX (National Commodity and Derivatives Exchange).

Options

Options give the purchaser the right, without imposing an obligation, to purchase or sell an asset at a predetermined price within a defined timeframe. They come with a strike price (the agreed buying or selling price) and an expiration date, after which the option is no longer valid.

Call Options: Give the buyer the right to purchase an asset at a specified price within a particular time frame. Allows the buyer to benefit from an increase in the underlying asset's price. If the asset's price rises above the strike price, the holder can exercise the call option, purchasing the asset at the lower strike price and potentially selling it at the higher market price for a profit.

Put Options: Contracts that grant the holder the right, but not the obligation, to sell an underlying asset at a predetermined price (strike price) within a specific period (until expiration). If the asset's price falls below the strike price, the holder can exercise the put option, selling the asset at the higher strike price and potentially buying it back at the lower market price, thus profiting from the price difference.

SWAPS

Swaps involve the exchange of cash flows or assets between two parties, often used to manage interest rates or currency risks.

Swaps are widely used for hedging against various risks like interest rates, currency, commodity prices, and credit risks. Swaps are predominantly traded over the counter, they are privately negotiated between parties, offering flexibility in terms and conditions.

Interest Rate Swaps (IRS): Exchange of fixed-rate and floating-rate interest payments. One party pays a fixed interest rate while the other pays a floating (variable) rate. Interest rate swaps are commonly used to hedge against interest rate risk or to modify the cash flow structure.

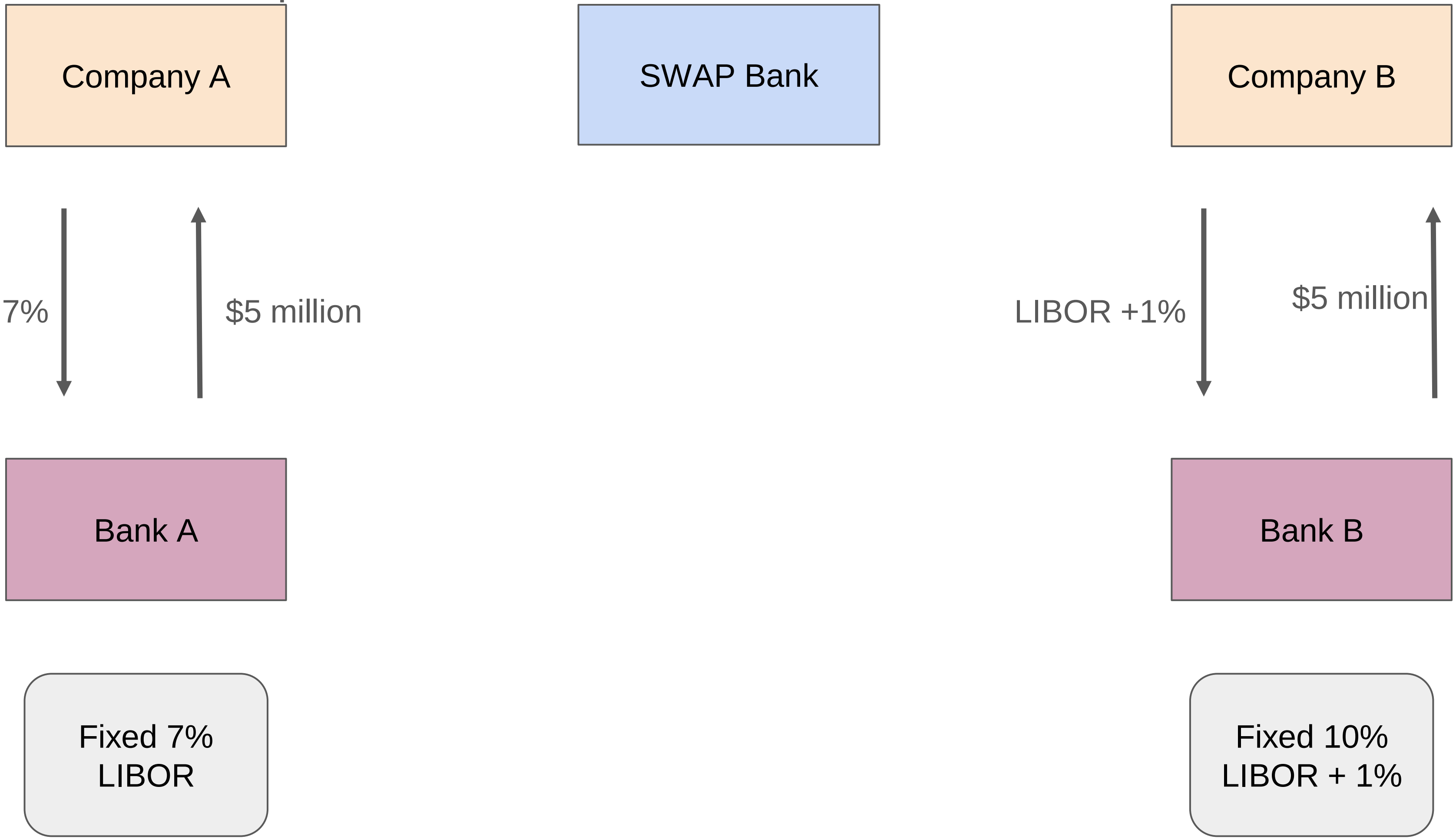
Currency Swaps: Two parties exchange a principal amount and interest payments in different currencies. Currency swaps help manage currency exposure and can be used to obtain better borrowing rates in different markets.

Commodity Swaps: Exchanging cash flows based on the future price of a commodity. These are utilized to hedge against commodity price fluctuations. Producers enter a commodity swap to lock in a fixed price for future production, ensuring predictable revenue regardless of market fluctuations.

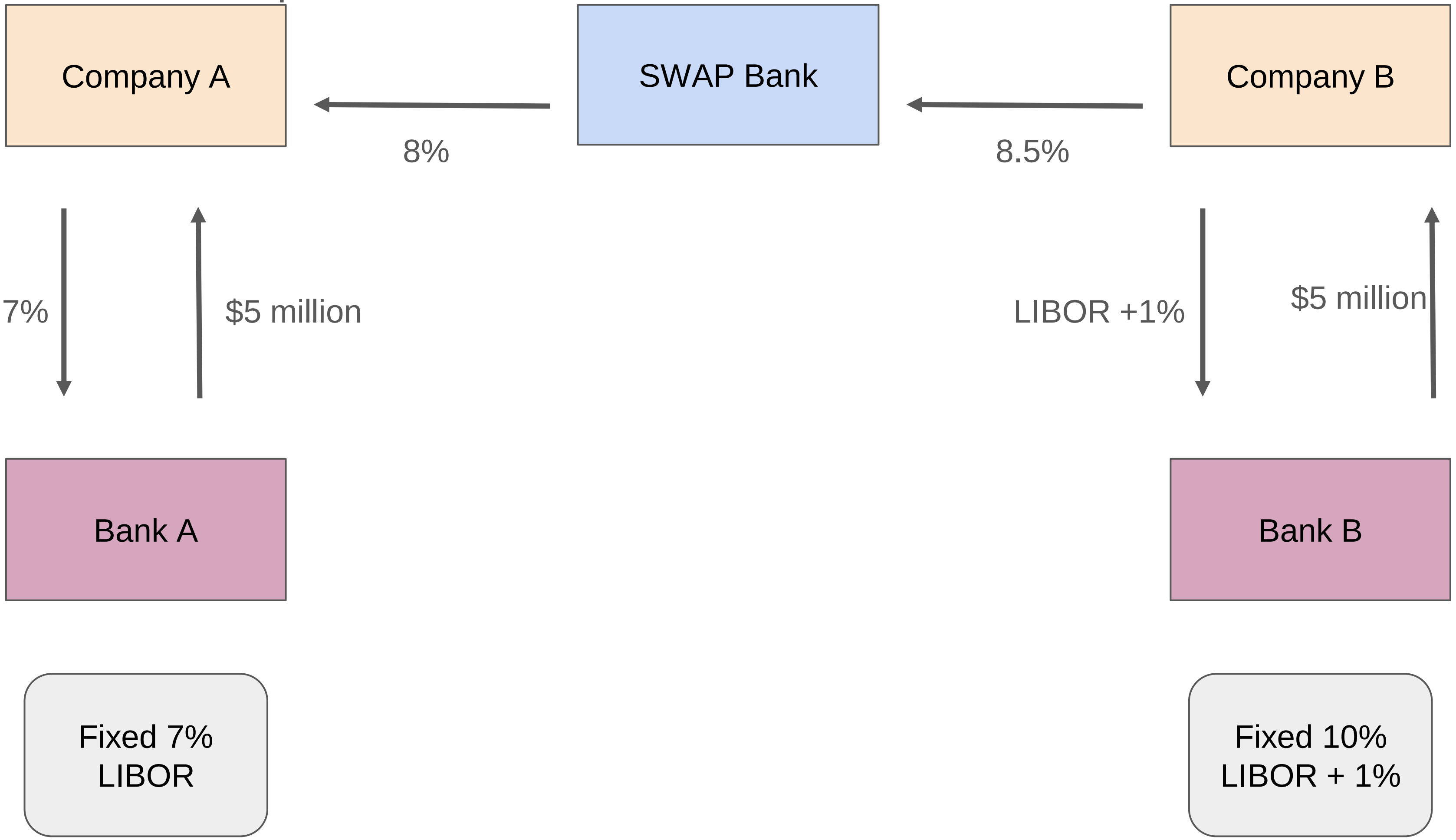
Credit Default Swaps (CDS): Financial derivatives transfer credit risk between two parties. The buyer of the swap pays a premium to the seller and receives protection in case of a credit event, like a default, on the underlying asset.

Interest rate swap

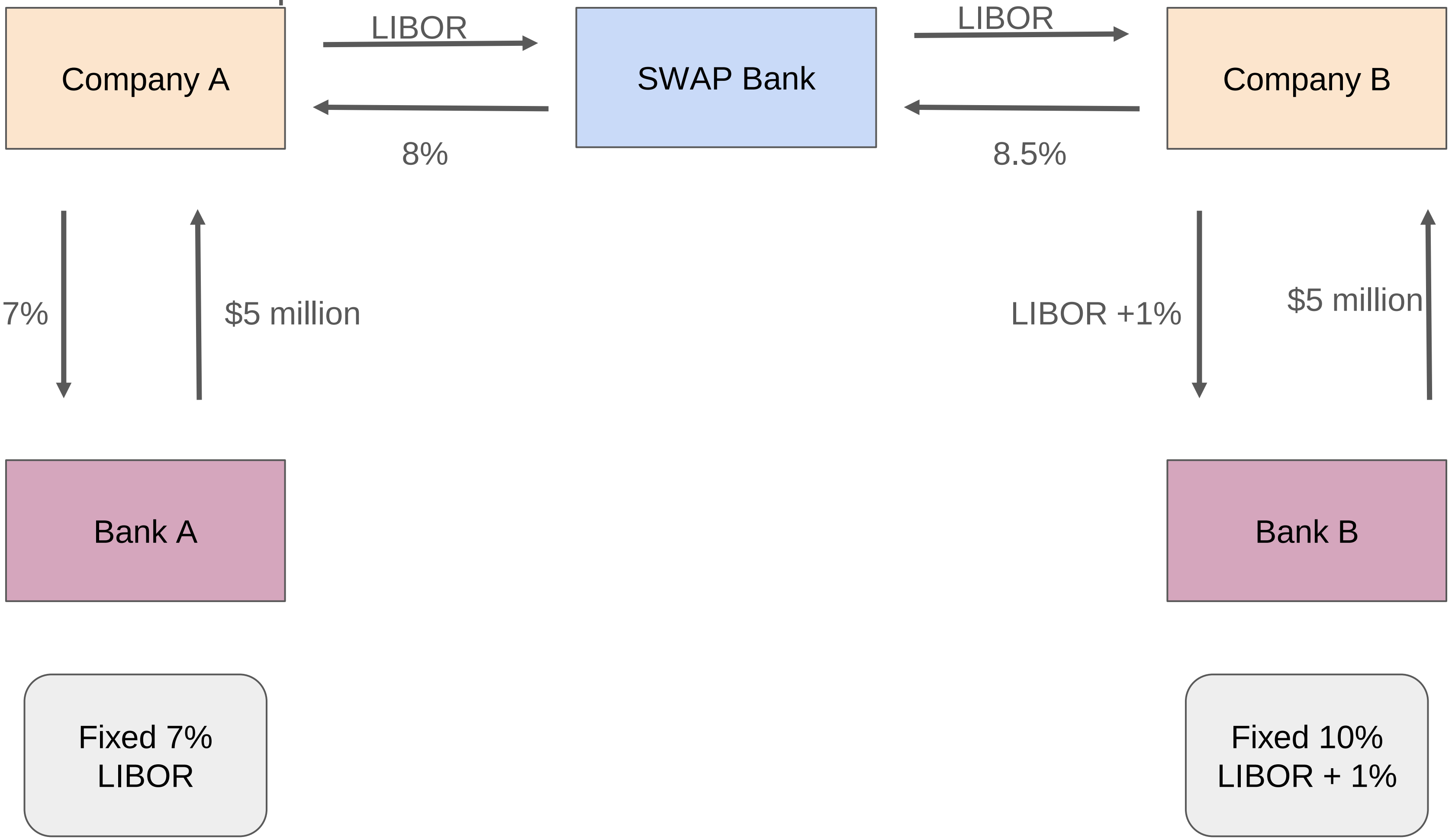
Interest rate swap



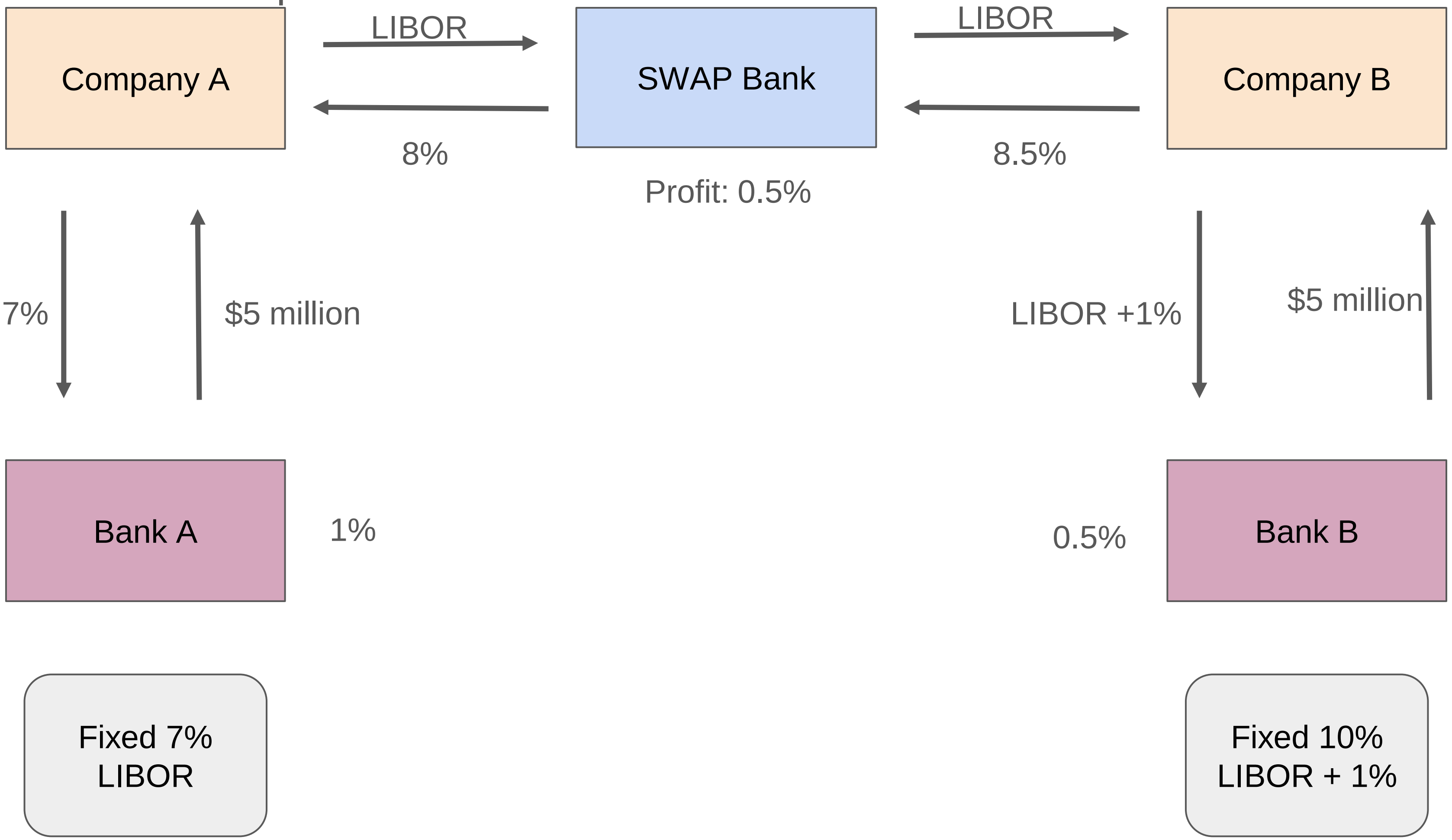
Interest rate swap



Interest rate swap



Interest rate swap



Foreign Exchange Market

The foreign exchange (forex) market allows participants, such as banks and individuals, to buy, sell, or exchange currencies.

It’s the largest financial market in the world

The forex market is an over-the-counter (OTC) market.

There exists a substantial amount of interbank forex trading, which helps determine swings in exchange rates. Large banks trade currencies to hedge, adjust balance sheets, and to trade on behalf of clients.

Bid Price: This is the rate at which a dealer is willing to buy your currency from you.

Ask Price: This is the rate at which a dealer will sell you currency.

The asking price will always be slightly higher than the bid price. This difference represents the dealer's profit margin, also known as spread.

Forex trading, or foreign exchange trading, is the buying and selling of currencies **in pairs** to profit from changing rates.

Stock market operations

Trading of Securities : Facilitates the continuous buying and selling of securities

Settlement and Clearing: Ensures transactions are settled efficiently through clearing corporations.

Price Discovery: Reflects the value of securities based on demand and supply

Transparency: Maintains fair trading practices and information disclosure

Functions of Stock Exchange

Facilitating trade: Provide a platform for trading securities in a regulated manner

Liquidity: Enable investors to convert securities into cash easily

Price discovery: Set prices based on real-time trading data and market conditions

Economic indicator: Reflect the economic performance through stock market indices

Investor confidence: Ensure trust by maintaining transparency and regulating trading practices.

Listing and formalities

Listing is the process by which a company’s shares are included on a stock exchange for trading.

Formalities for listing

- **Submission of Application**: The company applies to the stock exchange, submitting details about its operations, financials, and governance
- **Fulfillment of Criteria**: Must meet eligibility norms such as minimum capital, profitability, and public shareholding requirements.
- **Filing a Prospectus**: A detailed document is filed with the regulatory body (e.g., SEBI in India) and the stock exchange.
- **Due Diligence and Approval**: The exchange evaluates the company's financials, compliance, and corporate governance practices.
- **Listing Agreement**: The company signs an agreement to adhere to ongoing disclosure norms and regulatory guidelines.
- **Dematerialization:** Ensuring securities are converted to electronic form
- **Approval and Trading**: Once approved, the company's securities are listed and can be traded on the exchange.

Importance of Listing

- Enhances visibility and credibility of the company.
- Provides liquidity to shareholders.
- Facilitates raising additional capital in the future.

Obligation after listing

- Continuous Disclosures
- Compliance with Regulations
- Shareholder Communication:
- Maintenance of Public Shareholding

Stock Market Regulations

Regulatory bodies: In India, the Securities and Exchange Board of India (SEBI) oversees operations, ensuring fair practices and investor protection.

Compliance requirement: Listed companies must adhere to disclosure norms and regulatory guidelines.

Surveillance mechanism: Exchanges monitor trading to prevent market manipulation, insider trading, and fraud.

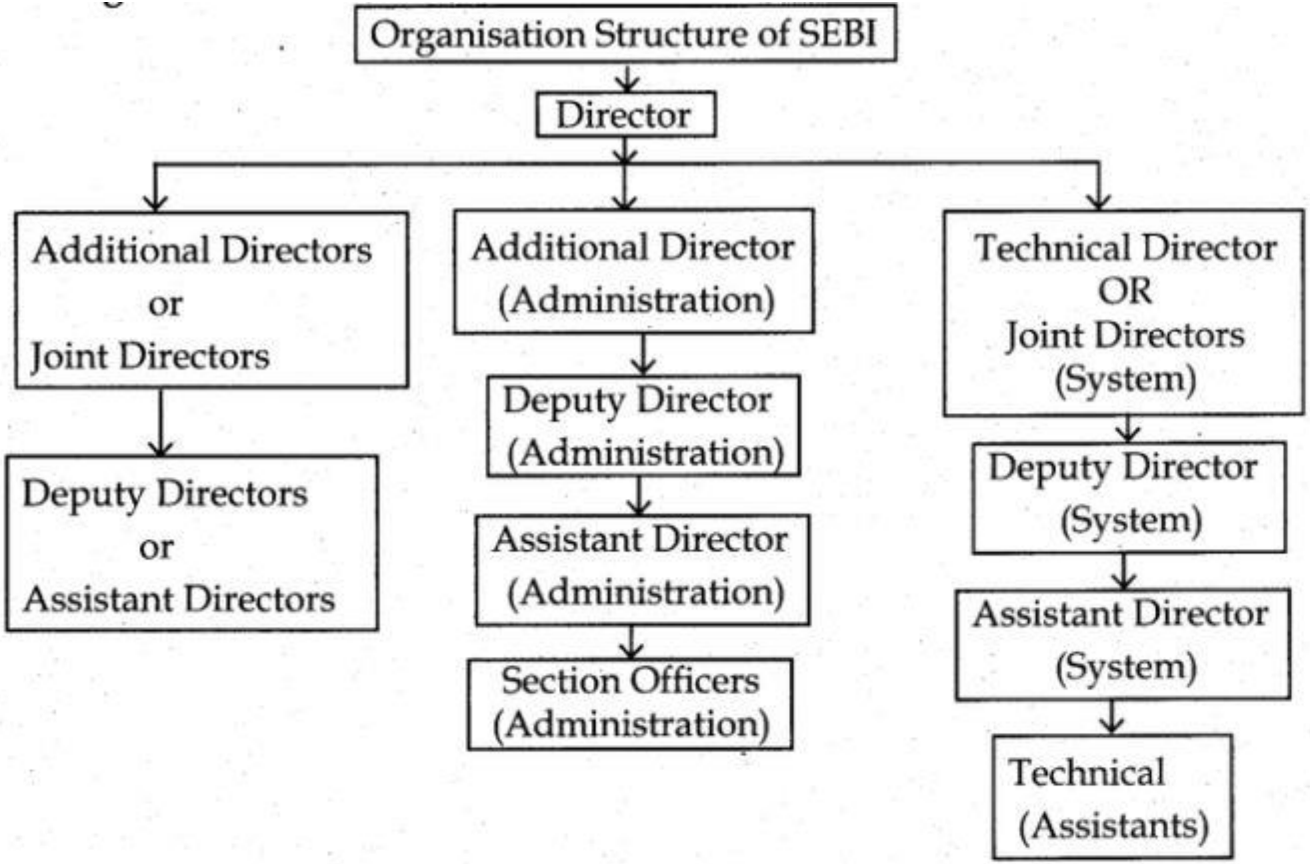
Investor protection: Rules to safeguard retail investors, including grievance redressal mechanisms.

SEBI

The **Securities and Exchange Board of India (SEBI)** was established in **1988** and given statutory powers through the **SEBI Act, 1992**. Its primary objective is to regulate the securities market, protect investors' interests, and promote the development of the capital market.

Objectives of SEBI

1. **Protecting Investors' Interests**: Ensuring that investors are not misled or defrauded and safeguarding their rights.
2. **Regulating the Securities Market**: Ensuring that the securities market operates in a fair, efficient, and transparent manner. Preventing the fraudulent practices and malpractices which are related to trading and regulation of the activities of the stock exchange
3. **Promoting Market Development**: Introducing innovations and reforms to enhance market accessibility and functionality.
4. **Preventing Malpractices**: Curbing insider trading, price rigging, and other fraudulent practices.
5. **Building Investor Confidence**: Encouraging participation by establishing trust in the regulatory framework.
6. To develop a code of conduct for the financial intermediaries such as underwriters, brokers, etc


Organisation Structure of SEBI
Director
Additional Directors or Joint Directors
Deputy Directors or Assistant Directors
Additional Director (Administration)
Deputy Director (Administration)
Assistant Director (Administration)
Section Officers (Administration)
Technical Director OR Joint Directors (System)
Deputy Director (System)
Assistant Director (System)
Technical (Assistants)

Functions of SEBI/ Role of SEBI

SEBI has the following functions

1. Protective Function

2. Regulatory Function

3. Developmental Function

Functions of SEBI: Protective Function

The protective function implies the role that SEBI plays in protecting the investor interest and also that of other financial participants. The protective function includes the following activities.

a. **Prohibits insider trading:** Insider trading is the act of buying or selling of the securities by the insiders of a company, which includes the directors, employees and promoters. To prevent such trading SEBI has barred the companies to purchase their own shares from the secondary market.

b. **Check price rigging:** Price rigging is the act of causing unnatural fluctuations in the price of securities by either increasing or decreasing the market price of the stocks that leads to unexpected losses for the investors. SEBI maintains strict watch in order to prevent such malpractices.

c. **Promoting fair practices**: SEBI promotes fair trade practice and works towards prohibiting fraudulent activities related to trading of securities.

d. **Financial education provider**: SEBI educates the investors by conducting online and offline sessions that provide information related to market insights and also on money management.

Functions of SEBI: Regulatory Function

Regulatory functions involve establishment of rules and regulations for the financial intermediaries along with corporates that helps in efficient management of the market.

The following are some of the regulatory functions.

a. SEBI has defined the rules and regulations and formed guidelines and code of conduct that should be followed by the corporates as well as the financial intermediaries.

b. Regulating the process of taking over of a company.

c. Conducting inquiries and audit of stock exchanges.

d. Regulates the working of stock brokers, merchant brokers.

Functions of SEBI: Developmental Function

Developmental function refers to the steps taken by SEBI in order to provide the investors with a knowledge of the trading and market function. The following activities are included as part of developmental function.

1. Training of intermediaries who are a part of the security market.

2. Introduction of trading through electronic means or through the internet by the help of registered stock brokers.

3. By making the underwriting an optional system in order to reduce cost of issue.

Powers of SEBI

Quasi-Legislative Powers:: SEBI can draft regulations to govern the securities market, such as the Listing Obligations and Disclosure Requirements (LODR) Regulations.

Quasi-Judicial Powers: SEBI can investigate and adjudicate on securities-related disputes, imposing penalties for violations of laws.

Quasi-Executive Powers: SEBI has the authority to inspect books of accounts, records, and other documents of market participants.

Power to Impose Penalties: SEBI can levy fines for violations, including insider trading, fraudulent practices, or non-compliance with disclosure requirements.

Prohibitory Powers: SEBI can restrict entities from accessing the capital markets if they are found guilty of misconduct.

Key initiatives by SEBI

Dematerialization: Introduction of electronic trading through depositories like NSDL and CDSL, reducing the risks associated with physical securities.

Investor Protection Fund: SEBI mandated the creation of funds to protect investors from risks associated with broker defaults.

Market Regulation: Implementing circuit breakers to prevent excessive volatility; Making it mandatory for companies to adhere to disclosure norms.

Mutual Funds Regulation: Streamlining the operations of mutual funds and ensuring transparency through the standardization of fees and expenses.

Insider Trading Regulations: SEBI has strict rules to prevent insider trading, with severe penalties for offenders.

Corporate Governance: Introduction of Clause 49 and other measures to ensure board independence and transparency in corporate decision-making.

Financial Service Sector Problems…

Limited Financial Inclusion:

- A significant portion of the population, particularly in rural areas, remains outside the formal financial system, lacking access to basic services such as banking, insurance, and credit.

Non-Performing Assets (NPAs):

- Public sector banks, in particular, face high levels of NPAs, which limit their ability to lend and affect profitability and capital adequacy.

Financial Service Sector Problems…..

Over-dependence on Banking:

- India’s financial system is heavily bank-dependent, with underdeveloped capital markets and corporate bond market, leading to limited long-term funding options.

Shadow Banking Risks:

- The rise of Non-Banking Financial Companies (NBFCs) has exposed vulnerabilities such as poor governance, liquidity crises, and overleveraging, as seen in the IL&FS crisis.

Financial Service Sector Problems….

Fragmented Regulation:

- Multiple regulators (RBI, SEBI, IRDAI, PFRDA, etc.) oversee different segments, leading to gaps, overlaps, and regulatory arbitrage.

Cybersecurity and Technological Challenges:

- With increasing digitization, the sector faces risks such as data breaches, fraud, and inadequate cybersecurity infrastructure.

Financial Service Sector Problems…..

Underdeveloped Corporate Bond Market:

- The lack of a vibrant corporate bond market limits options for long-term project financing, forcing companies to rely excessively on bank credit.

Low Retail Participation in Capital Markets:

- Despite reforms, the participation of retail investors in equity and debt markets remains limited due to low financial literacy and risk aversion.

Financial Service Sector Problems…..

High Cost of Financial Services:

- Interest rates, insurance premiums, and asset management fees remain high, discouraging wider adoption among low- and middle-income groups.

Corporate Governance Issues:

- Weak governance and accountability in financial institutions have led to mismanagement and fraud, eroding public trust.

Insufficient Innovation in Rural Credit:

- Traditional lending practices fail to meet the needs of rural populations, with inadequate credit availability for agriculture and small businesses.

Financial Service Sector Reforms

Banking Sector Reforms:

- Implementation of the **Insolvency and Bankruptcy Code (IBC), 2016** to address bad loans efficiently.
- Recapitalization of public sector banks to strengthen their balance sheets.
- Introduction of the **Privatization Drive** to improve efficiency and reduce fiscal burdens.
- Creation of the **National Asset Reconstruction Company Limited (NARCL)** to manage stressed assets.

Capital Market Reforms:

- **SEBI's Role**: Strengthened regulations to prevent insider trading, price rigging, and ensure transparency.
- Introduction of **T+1 settlement cycle** for quicker transactions.
- Development of Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) to attract investments.

Financial Service Sector Reforms…

Financial Inclusion Initiatives:

- Launch of **Pradhan Mantri Jan Dhan Yojana (PMJDY)** for universal banking access.
- Expansion of the **Aadhaar-linked Direct Benefit Transfer (DBT)** system.
- Growth of fintech solutions and digital payments through initiatives like **UPI** and **RuPay cards**.

Corporate Bond Market Reforms:

- Introduction of **Electronic Bidding Platforms (EBP)** for private placements.
- Relaxation of investment norms for insurance and pension funds in bonds.
- SEBI’s efforts to create a robust framework for credit rating agencies.

Financial Service Sector Reforms….

Insurance and Pension Reforms:

- Increase in the **FDI limit in insurance** from 26% to 74%.
- Promotion of micro-insurance products for rural areas.
- Strengthening the **National Pension System (NPS)** to encourage long-term savings.

NBFC Sector Reforms:

- RBI’s tighter regulations for NBFCs to ensure adequate capitalization and liquidity.
- Implementation of scale-based regulations to categorize NBFCs based on their size and activities.

Financial Service Sector Reforms…..

Digital Transformation:

- Launch of **Account Aggregator Framework** to facilitate secure data sharing between financial institutions.
- Promotion of digital banking units and the introduction of **Digital Payments Index** for monitoring progress.

Governance and Accountability:

- Enhanced disclosure norms for financial institutions.
- Strengthening the role of independent directors and auditors.
- Penalties for non-compliance with governance standard

Financial Service Sector Reforms…

Foreign Investment and Globalization:

- Liberalization of FDI policies in banking, insurance, and asset management.
- India’s participation in international financial regulatory bodies like the **Financial Action Task Force (FATF)** and **Basel Committee**

Investor Protection Mechanisms:

- Creation of **Investor Education and Protection Fund (IEPF)**.
- Introduction of funds like the **Investor Protection Fund (IPF)** to safeguard investors from broker defaults.