

Objectives

At the end of this chapter, students should be able to:

- Explain the meaning of financial system;
- Identify and define the components of the financial system;

20.1 Introduction

The financial system is the system that allows the transfer of money between savers and borrowers. It comprises a set of complex and closely interconnected financial institutions, markets, instruments, services, practices and transactions.

For example: Bank, Insurance Companies, Nigeria Stock Exchange, Security exchange commission (SEC). Cooperative Societies (CICS).

Meaning of the Components of the Financial System Bank:

This is a commercial institution which performs various financial activities e.g. accepting and handling of deposits of its customers. It is a body of persons who carry on the business of banking. Banks are institutions that create money and give out loans to people. In summary, a bank is a place where money and other valuables like wills, jewelry, certificates and are kept. Examples of banks: commercial bank, central bank, merchant bank, development bank.

20.2 Insurance Organisations

Insurance can be defined as agreement whereby one party promises to indemnify or agrees to give another party a sum of money in the event of his suffering a specified loss or damages. It can also be defined as a system for providing loss, the payment being made from the accumulated contributions of all parties participating in the fund or scheme. The main principle of insurance is the pooling of risks. The insurer will collect premium from a group of people who suffer similar risk to create a common fund out of which compensation will be paid to those who suffer losses. Compensation for victims will depend on the premium paid and the extent of losses suffered.

20.3 Nigerian Stock Exchange

The stock exchange market is a highly-organised market where investors can buy and sell existing securities like shares, stocks, debentures and gilt-edge. This is a market where those who are interested in purchase of securities are brought into contact with the sellers. The stock exchange is an essential part of the capital market. It serves as a source of raising capital as well as a forum for financial investment. The markets deal with old existing shares only because the new ones are not traded in it. The stock exchange market ensure that every transaction must follow prescribed set of rules and regulations which are complex in nature.

20.4 Money Market

This contrasts with the capital market for long-term funding; which is supplied by bonds and equity. Financial companies, such as Government Marketing Agency Companies (GMAC), typically fund themselves by issuing large amount of Asset-Backed Commercial Paper (ABCP) which is secured by the pledge of eligible assets into an asset backed commercial paper conduit. Examples of eligible assets include; auto loans, mortgage - backed securities and similar financial assets. Certain large corporations with strong credit ratings, such as the Power Holdings Plc, issue commercial paper on their own credit. Other large corporations arrange for banks to issue commercial

papers on their behalf via commercial paper lines.

20.5. Features of the Money Market

The following are the features of the money market:

1. This consists of banks borrowing and lending to each other using commercial paper purchase agreement and similar Instruments it consist of financial institution and dealers in money (i.e. borrowing and lending)
2. The instruments are often bench marked to (i.e. price by reference to) London Interbank Offered Rate (LIBOR) for the appropriate terms and currency. It trades in short term financial instrument commonly called .paper.
3. Operation in money market includes; commercial banks, stock exchange, insurance e.t.c.

20.6 Market Institutions

Market institutions are those institutions that are involved in marketing fund through one way or the other. They include banks, (commercial and mortgage banks) insurance companies, stock exchange markets etc.

20.7 Capital Market

A capital market is the market where government or a corporated company (usually a corporation) can raise money (capital) to fund their operations and long term investment, Selling bonds and selling stocks are two ways to get capital from this market thus bond markets and stock market are considered capital markets.

Primary Markets

In the primary markets, shares and stocks are fixed prices at which the stock exchange market will sell them to different investors. In the primary market, the shares are sold and resold to investors.

Secondary Markets

At the secondary markets, the stocks and shares prices are already fixed, Investors are advised on how to invest and all types of stocks and shares are made available at the secondary markets also fund can be raised or mobilised by organisation investors. Securities are sold in the secondary markets.

20.8 Functions of Capital Market

- (i) **Fund Mobilisation:** Through the capital market, funds or capital can be raised or mobilised by companies.
- (ii) **Sale of Securities:** Investors can buy and sell old securities likes stocks and shares.
- (iii) **Market for Investment:** It is a market where people can invest their money in shares of companies.
- (iv) **It facilitates the transfer of Shares:** Capital Market facilitates the transfer of ownership of shares between investors. Investors who want to withdraw from one company to another can do so without any hindrances.
- (v) **Provides Avenue for Government to Raise Fund:** Government can raise fund by selling bond or gilt-edged in the stock market.
- (vi) **Valuation of Price of Securities:** The market, through the forces of demand and supply can fix prices of securities.
- (vii) **Provision of Professional Advice:** The capital market provides professional advice to investors on sales and management of securities.
- (viii) **Provision of Rules and Regulations:** The capital market is charged with the responsibility of providing rules and regulations that will ensure smooth operation on the flow of the capital market.
- (ix) **Encourage Companies to be more efficient:** The capital market ensures that companies quoted in the stock exchange have good Reputation; this will gear up companies to perform well so that they can be listed.

20.9 Features of Capital Market

- (i) It is a market where funds are raised for government and individuals through the sales of shares.
- (ii) It consists of both primary market and secondary market.
- (iii) It offers professional advice and encourages companies to grow.

Features of Insurance

- (i) It covers risk.
- (ii) It is associated with payment of premium by the insured.
- (iii) It operates through insurance brokers.
- (iv) It is associated with issuance of insurance policies.
- (v) it pays compensation in accordance with insurance policies.
- (vi) It reduces risk and provides a means of saving.

20.10 Summary

In this chapter, student have learnt that:

1. The Financial system is a market where the transfer of money between borrower and lender take place.
2. Money market and capital market operate in the financial market.
3. Money is for short term loan and capital market is for long term loan and investment.
4. Stock exchange is a market where those who are interested in buying and selling shares are brought into contact.
5. That insurance reduces risk and provides a means of saving

20.11 Revision Questions

1. What is financial system?
2. Differentiate between money and capital market.
3. State five examples each of money and capital market.