UNIT ONE

THE FINANCIAL SYSTEM IN PERSPECTIVE

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1.1 Concept of the Financial System

A **financial system** is a network of financial institutions, financial markets, financial instruments and financial services to facilitate the transfer of funds. The system consists of savers, intermediaries, instruments and the ultimate user of funds. The level of economic growth largely depends upon and is facilitated by the state of financial system prevailing in the economy. Efficient financial system and sustainable economic growth are corollary.

The financial system consists of the group of institutions in the economy that helps to match one person's saving with another person's investment. The primary task of the financial system is to move scarce loan able funds from those who save to those who borrow to buy goods and services and to make investments so that the economy can grow and increase the standard of living enjoyed by citizens. The end users of this system are people and firms whose desire is to lend and to borrow.

The financial system moves the economy's scarce resources from savers to borrowers. The financial system determines both the cost of credit and the amount of credit available to pay for the thousands of different goods and services we purchase daily. Equally important, what happens in this system has a powerful impact upon the health of the economy of a nation. When credits become more costly and less available in which total spending for goods and services fall.

As a result, unemployment rises and the economy's growth slows down as businesses cut back their production and lay off workers. In contrast, when the cost of credit declines and loan able funds become more available, total spending in the economy often increases, more jobs are created and the economy's growth accelerates.

The financing system is necessary to mobilize surplus funds from people and organizations, and to allocate them among deficit people and organizations. An investor (who invests in securities) is an example of a surplus unit, whereas a borrower is an example of a deficit unit. Mobilizing funds generates returns for surplus units, which generally enhances their wealth and economic well-being. It also allows deficit units to enhance their productive and purchasing capacities, and thus improves an economy's production and consumption potential.

The financing process allows prospective users of funds to compete for them and creates the incentive for funds to be supplied. In essence, the financial system should ensure the supply of funds when their use has a net present value. That is, the user of the funds expects to earn a return that exceeds the returns paid to the supplier of the funds. Funds are mobilized either as debt or equity. Debt funds are supplied as a loan and generally the repayments are scheduled, whereas equity funds acquire part ownership of a business and their returns depend on the future profitability of the business.

The financing process requires the comprehensive disclosure of relevant information to allow investors and other suppliers of funds to assess the risks and expected returns associated with the proposed use of funds.

To sum up, economic development is partially dependent on the financial system to help mediate the transfer of money to areas of the economy that need it most. The financial system has a number of key functions, which help facilitate these shifts in money that are important for sustainable economic growth.

The financial system allows you to place your excess money into a savings account in a bank of your choice. Keeping your money in a bank safeguards your savings, and the bank pays you interest based on the amount you keep in your account. Money in deposit accounts, like savings accounts, is used to provide loans for a wide range of projects to people and businesses. Mortgages, car loans and student loans are financed largely by deposits in banks, savings institutions and credit unions.

When businesses raise capital, they sell stock to investors. Investors give their money to the company in exchange for ownership in the company. Businesses may expand their operations or finance growth by issuing debt instruments called bonds. Bonds are bought and sold through the financial system. Bond markets allow businesses to access investor capital to finance their growth, while bond investors have an opportunity to profit from helping finance business expansion. Governments may finance programs or deficit spending through the financial system by issuing bonds to raise money. Investors may buy government bonds to own a part of government debt, and collect interest

payments from the government. In turn, the government has the money it needs to continue to function.

1.2 Functions of the Financial System

Financial system in today's world is perhaps the most important system among all the systems as all the economics of the world have become interlinked- it has become a very complex system. The financial system in it, includes all whether its banks or stock market or financial institutions.

- ***Let's see some of the important functions which are performed by the financial system:***

1. Liquidity Role/ Function

Financial system enhances liquidity of financial claims. To put it differently, financial system also makes sure that one can liquidate his or her savings whenever he or she wants it and therefore individuals can have both the things, which involve return on investments as well as comfort that they can liquidate their investments whenever they want.

It is a means of raising funds by converting securities and other financial assets into cash balances. The financial system provides liquidity for savers holding financial instruments but who are in need of money. Money can be spent as it is without the necessity of converting it into some other form. However money generally earns the lowest rate of return of all assets traded in the financial system, and its purchasing power is seriously eroded by inflation. That is why savers generally minimize their holdings of money and hold bonds and other financial assets until spend able funds really are needed.

2. Wealth Role/Function

It is shifting power from high earning periods to warnings periods of life. For the business and individuals choosing to save, the financial instruments sold in the money and capital markets provide an excellent way to store wealth (to preserve value or hold purchasing power) until funds are needed for spending in the future periods.

While we might choose to store our wealth in things" (e.g. automobiles and clothes), such items are subject to depreciation and often carry great risk of loss. However, bonds, stocks, deposits and other financial instruments, do not wear out overtime, usually generate income, and normally, their risk of loss is less as compared to many other forms of stored wealth.

3. Credit Role/Function

The role of credit is to provide a continuous supply of credit for the business, consumers and governments; to support both the consumption and investment

spending in the economy. Example, Governments borrow funds to construct public facilities and to cover daily expenses until tax revenues flow in.

4. Saving Role/Function

The first and foremost function which financial system perform is the channelization of the savings of individuals and making it available for various borrowers which are the companies that take loan in order to increase the production of goods and services, which in turn increases the overall growth of the economy.

The system of financial markets and institutions provides a conduit for the public's savings. Bonds, stocks, deposits, and other financial claims sold in the money and capital markets provide a profitable, relatively low-risk outlet for the public's savings. When savings flow decline, however, the growth of investment and living standards tends to elevated. The savings function of any financial system supplies the vital raw material of funds to invest so that economic growth and living standards can flourish.

5.* Payments Role/ Function*:

The financial system ensures the efficient functioning of the payment mechanism in an economy. All transactions between the buyers and sellers of goods and services are effected smoothly because of financial system. In other words, it is with the help of financial system that one can make payment whenever and wherever he or she wants with the help of checks, credit card and debit card. It provides a mechanism for making payments to purchase goods and services; certain financial assets, mainly checking accounts and now negotiable order of withdrawal accounts, serve as a medium of exchange in the making of payments.

Example: Credit cards (plastic credit cards) give the customer instant access to short-term credit but also is widely accepted as a convenient means of payment. Debit card (plastic credit cards) - is used today to charge a buyer's deposit account for purchases of goods and services and transfer the proceeds instantly by wire to the seller's account. Debit cards and other electronic means of payment, including computer terminals at homes, offices, and stores are likely to displace checks and other pieces of paper as the principal means of payment.

6. Policy Role/Function:

In recent decades, the financial market has been the principal channel through which the federal government has carried out its policy of attempting to stabilize the economy and avoid excessive inflation by manipulating the interest rate and the availability of credit.

7. Risk Role/Function:

Financial system helps in risk transformation by diversification, as in case of mutual funds. Financial system also provide an individual various options when it comes to protecting against various risks like, risk arising from

accidents, health related, etc… through various life insurance options. Financial markets and the diverse financial instruments traded in those markets allow investors with the greatest taste for risk.

The financial markets offer business, consumers and governments protection against life, health, property and income risks. Thus, capital markets allow the risk that is inherent to all investments to be borne by investors most willing to bear that risk. This allocation of risk also benefits the firms that need to wise capital to finance their investments. When investors can self-select into security types with risk-return characteristics, that best suits their preferences, each security can be sold for the best possible price. This facilitates the process of building the economy's stuck of real assets.

In addition to the above major roles/functions the financial system can perform different functions as follows:

- Financial system works as an effective conduit for optimum allocation of financial resources in an economy.
- It helps in establishing a link between the savers and the investors.
- Financial system allows 'asset-liability transformation'. Banks create claims (liabilities) against themselves when they accept deposits from customers but also create assets when they provide loans to clients.
- Economic resources (i.e., funds) are transferred from one party to another through financial system.
- Financial system helps price discovery of financial assets resulting from the interaction of buyers and sellers. For example, the prices of securities are determined by demand and supply forces in the capital market.
- Financial system helps reducing the cost of transactions.

1.3. Financial Assets

A financial asset is an intangible representation of the monetary value of a physical item. It obtains its monetary value from a contractual agreement of what it represents. While a real asset, such as land, has physical value, a financial asset is a document that has no fundamental value in of itself until it is converted to cash. Common types of financial assets include certificates, bonds, stocks, and bank deposits.

One of the most common types of financial assets is a certificate of deposit (CD). A CD is an agreement between an investor and a bank in which the investor agrees to keep a set amount of money deposited in the bank in exchange for a guaranteed interest rate. The bank may offer a higher amount of interest payment since the money is to remain untouched for a set period of time. If the investor withdraws the CD before the end of the contract terms, he or she will lose out on the interest payments and be subject to financial penalties.

Another type of financial asset is a bond. Bonds are often sold by corporations or governments to investors in order to help fund short-term projects. They are a type of legal document detailing the amount of money an investor loaned a borrower and the length of time it needs to be paid. A bond represents how much interest is guaranteed to be returned to the investor along with the original loan amount.

Stocks are one of the only financial assets that do not have an agreed upon ending date. Investing in stock means the investor has part ownership of a company and shares in the company's profits and losses. He or she can keep the stock for any length of time or decide to sell it to another investor.

Money that is deposited into a bank account also counts as a financial asset, rather than a real asset. When cash is put into a bank account, the proof of the funds is a bank statement that summarizes the value of the account. Deposited cash is not considered a physical asset because the bank uses the money to fund its business and agrees to return it when the account holder decides to withdraw it.

Valuation of financial assets is the process of determining the amount of cash the assets can be converted to. This process is often used to find out a person's personal wealth for legal reasons, such as his or her ability to pay off a debt.

A financial asset is typically given a maturity date in a contractual claim. If it remains untouched and unconverted to cash by that date, its value will usually increase. Cashing out an asset before its maturity date can ultimately cost a person financial penalties because it violates the terms of the agreement.

1.3.1 Classifications of Financial Assets

A financial asset is an economic resource, which is published by economic institutions, all prisoners as a positive economic value can be considered a financial asset. When the Real assets represent the investments we can put our hands on, sometimes referred to as real property, including real estate, machinery and equipment, precious and common metals, and oil; our financial assets comprise more of the intangible investments (things we cannot touch).
They represent our equity ownership of a company, or they provide evidence that someone owes us a debt, or they show our right to buy or sell our ownership interest at a subsequent date.

Financial assets include common stock, options and warrants to buy stock at a later date, money market certificates, savings accounts, Treasury bills, commercial paper (unsecured short-term debt), bonds, preferred stock, and financial futures (contracts to buy financial instruments at a later date).

- ***The Financial assets can be defined or characterized by three parameters or characteristics which are:***

Liquidity: Liquidity can be defined as the ability to convert into cash each resource. Investors, companies and even governments often need to liquidate their assets to obtain sufficient capital to support the different functions of the economy. The money received is used primarily to repay debt or invest in new business ideas.

Security benefits: it is determined by the amount of compensation that can generate an advantage for the investor. For example, investing in shares of various companies is determined by shareholders dividends in return. Be achieved if the dividend is high, then the assets (shares) as "the best performing asset" means.

Risk: It can be defined as the probability or possibility of loss of investment of economic resources. The risk of a financial asset depends on two factors: The creditworthiness of the issuer and guarantees associated with the financial asset.

This line of business is very important for any financial institution. The effectiveness and sustainability of a company depend on the assets, liabilities ratio. If the economic resources of the institution within its financial obligations, the institution is unable to collect the debt from various sources to repay. In such a situation, the companies can even bankruptcy, leading to deterioration of the economy of the nation.

In addition, shareholders and employees of the company and lose their money or job. Thus, any society, a management team that is responsible for the care of economic resources and also ways to improve so that financial obligations can be paid is effectively. Country governments have asset management departments of Finance to keep track of all debts and economic resources to support a favorable economic growth.

- ***Financial assets can be categorized as given bellow based different classification bases;***

A) Debt Securities and Equity Securities:

i. Debt securities

Debt securities are securities in which the borrower agrees to pay periodic interest and principal. They may be issued by Corporations, Financial Institutions, or Governments. Debt securities include securities like: Bonds, Treasury bill, Commercial paper, Promissory notes, Bankers' acceptances, Life insurance policies, Certificate of deposits, and Repurchase agreements (repos).

ii. Equity securities

Equity securities represent ownership in a business firm. They are claims against the firm's profits and proceeds from the sale of its assets upon liquidation. They usually include common stock and preferred stock.

B) Cash instruments and derivative instruments:

i.Cash instruments

Cash instruments are instruments whose values are determined by the markets. They include instruments like: Money (coins, currency, and checks), Common Stock, Preferred Stock, Bonds, Treasury bill, Commercial paper (Promissory notes, Bankers' acceptances, Life insurance policies), Certificate of deposits, and Repurchase agreements (repos)

ii.Derivative instruments

Derivative instruments derive value from some other instruments. They include instruments like options, bond futures, warranties, swaps etc.

C) Negotiable and Non-Negotiable Instruments:

i. Negotiable Instruments

Negotiable instruments are securities that can be easily transferred from one holder to another. Their claims are paid to the bearer of the instrument. They may be classified in to payable to order, and payable to bearer. An instrument is said to be payable to order if it is transferred to another party by endorsement at the back of the instrument. On the other hand, an instrument is said to be payable to bearer if it is transferred to another party by delivery. Negotiable instruments include instruments like Bonds, Checks, Stock, Treasury Bill, etc

ii. Non-negotiable Instruments

Non-negotiable instruments are securities that can not legally be transferred from one party to another party. They include instruments like: Saving accounts, Bill of lading, Air waybill, Crossed check (a crossed check can only be deposited in a bank-account and, unlike a bearer check, cannot be cashed over a bank's counter), Warehouse Receipts, Letter of credit, etc

1.4. Financial Intermediaries

The term financial intermediary may refer to an institution, firm or individual who performs intermediation between two or more parties in a financial context. Typically the first party is a provider of a product or service and the second party is a consumer or customer. Financial intermediaries are banking and non-banking institutions which transfer funds from economic agents with surplus funds (surplus units) to economic agents (deficit units) that would like to utilize those funds. Financial intermediaries can be:

- Banks;
- Building Societies;
- Credit Unions;
- Financial adviser or broker;
- Insurance Companies;
- Life Insurance Companies;
- Mutual Funds; and
- Pension Funds.

1.4.1 Classifications of Financial Intermediaries

1.4.1.1 As Fee-based and Asset Based Intermediaries

i. ***Fee Based/Advisory Financial Intermediaries:***

These Financial Intermediaries/Institutions offer advisory financial services and charge a fee accordingly for the services rendered. Their services include***:***

- Issue Management
- Underwriting
- Portfolio Management
- Corporate Counseling
- Stock Broking
- Syndicated Credit
- Arranging Foreign Collaboration Services
- Mergers and Acquisitions
- Debenture Trusteeship
- Capital Restructuring

ii. ***Asset-based Financial Intermediaries:***

These financial Intermediaries/Institutions finance the specific requirements of their clientele. The required infra-structure, in the form of required asset or finance is provided for rent or interest respectively. Such companies earn their incomes from the interest spread, namely the difference between interest paid and interest earned.

The financial institutions may be regulated by various regulatory authorities, or may be required to disclose the qualifications of the person to potential clients. In addition, regulatory authorities may impose specific standards of conduct requirements on financial intermediaries when providing services to investors.

1.4.1.2 Deposit-type, Contractual Savings, Investment Funds and Others

I. DEPOSIT-TYPE INSTITUTIONS

Depository-type institutions are the most commonly used types of financial intermediaries because people use their services on a daily basis. Depository institutions offer different types of checking or savings accounts and Time Deposit s. Depository Institutions use the deposits to make loans such as mortgages, consumer loans and business loans.

➧ **Types of depository institutions are listed and briefly explained below:**

A. ***Commercial Bank s:*** Commercial Banks are the largest among all financial intermediaries and are also the most diversified due to the large range of assets and Liabilities they hold. Their liabilities are in the form of checking and savings deposits, and various types of time deposits. The assets that commercial banks hold are securities of various forms and denominations such as mortgage loans, consumer loans, business loans and loans to state and local governments. Commercial banks are among the most regulated forms of business due to their vital role in the well-being of the economy.

B. ***Thrift Institution s:*** Savings and loans associations and mutual savings banks are often called thrift institutions. Thrift institutions offer checking and savings accounts and other various types of time-deposits and use these funds to purchase long-term mortgages. Savings and loans are the largest residential mortgage lenders. Thrift Institutions specialize in maturity inter mediation since they take liquid deposits and lend the out in the form of long-term Collateralized loans.

C. ***Credit Union s:*** Credit Unions are small non-profit depository institutions that are owned by their members who are also their customers. Members of credit unions all have a common bond such as military service, occupation etc... Credit union's primary liabilities are checking deposits (share drafts) and savings accounts (share accounts) and credit unions usually make their investment s in the form of short-term installment consumer loans. The most significant difference between credit unions and commercial banks are the restrictions that most loans are made to consumers only, the common bond requirement for members, the non-profit nature and the tax exemptions due to their cooperative nature.

II. CONTRACTUAL SAVINGS INSTITUTIONS

These are savings institutions that obtain their funds through long-term contractual arrangements and invest these funds on the capital markets. Insurance companies and Pension Funds are contractual savings institutions. They usually have a steady inflow of funds from their contractual arrangements therefore they usually don't experience difficulties with Liquidity and can make long-term investments in securities such as bonds and sometimes common stock. Types of Contractual Savings Institutions are listed and briefly explained below:

A. ***Life Insurance Companies***: Life insurance companies issues securities which are claims meant to protect individuals and families from events such as premature death or early retirement. In the event of early death or retirement the beneficiaries receive benefits that were promised in the contract. Many life insurance companies also offer some savings to their policy holders. Since their cash-flows are

predictable they are able to invest in long-term securities that provide higher yields. Life Insurance companies are regulated by the states they operate in unlike depository institution which are regulated by the federal government.

B. ***Casualty Insurance Companies***: These types of insurance companies sell policies that protect individuals or businesses against loss of property from fire, theft, accidents or other causes that can be predicted through statistical models. Casualty insurance companies' primary source of funds comes from premiums charged to the policyholders. Unlike life insurance companies, the cash outflows of casualty insurance companies are not as predictable; therefore they invest their funds in short-term, highly marketable securities.

C. ***Pension Funds:*** Pension funds generally acquire funds from employer and employee contributions while the employee is still working and provide the employee with payments during retirement.

Pension funds usually invest funds in corporate bonds and equities. Pension funds are beneficial to individuals because they help employees plan and save for retirement. Because of the long-term investment nature, pension funds generally invest in long-term, higher yield securities.

iii. Investment Funds

A. **Mutual Fund**: Mutual funds pool together funds from investors and then build a Portfolio consisting of equities and bonds. The investors own shares which represent a portion of the mutual fund pie. The amount of shares an investor owns is dependent on the amount of money he or she contributed. Mutual funds are beneficial to small investors because they offer diversification, economies of Scale for transaction costs, and professional portfolio management. The value of a mutual fund's share is not fixed; it fluctuates with the change in value of the mutual fund's portfolio**.** Different mutual funds specialize in different sectors. Some mutual funds specialize in high-risk growth stocks which are good for young and risk tolerant investors while others specialize in income type securities which are better for older retired individuals who need income to pay for their living expenses.

B. **Money Market Mutual Funds:** A Money Market Mutual Fund (MMMF) is simply a mutual fund that strictly invests its pool of funds in money market securities which are short-term securities with low default-risk. These securities are usually sold in large capital; therefore most investors don't have enough money to purchase them directly. MMMF's offer small investors the opportunity to invest in these short-term securities without taking on huge financial risks.

MMMF's generally allow investors to write checks and make withdraws making them competitive with checking and savings accounts. However, there are usually limits on how many withdraws can be made and the accounts are not insured.

iv. Other Types of Financial Intermediaries

a) **Finance Companies:** Finance companies obtain most of their money by issuing commercial paper (short-term IOU's) to investors, and the rest is obtained from the sale of Equity capital and long-term debt obligations. Finance companies then take this money and make loans to consumers and businesses. There are three basic types of finance companies:

(1) Consumer finance companies which specialize in loans made to households,
(2) Business finance companies which make loans and leases to businesses, and
(3) Sales finance companies which finance the items that are sold by retail stores.

b) **Federal Agencies:** The Federal Governments act as a Financial Intermediary through its agencies which take part in financial intermediary type transactions. The goal of federal agencies is to reduce the costs of borrowing funds in order to increase the flow of funds in certain sectors of the economy. Government agencies achieve this by selling Debt securities called agency securities and then lending the funds from the sale to the economic sectors they serve. These agencies usually serve the housing sector and agriculture sector because many argue that these sectors would not be able to obtain credit at a reasonable cost if the government did not take direct intervention.

1.4.2 Financial Intermediaries as Markets for Firm's Assets

Financial intermediaries appear to have a key role in the restructuring and liquidation of firms in distress. In particular, there is rich evidence that financial intermediaries play an active role in the reallocation of displaced capital, meant both as the piece-meal reallocation of assets (such as the redeployment of individual plants) and, more broadly, as the sale of entire bankrupt corporations to healthy ones.

In some countries a function of banks during reorganizations is to "use bank contacts to facilitate a merger with another firm as a means of resolving the crisis". Knowing possible synergies among firms, banks can suggest solutions for the efficient reallocation of assets and of corporate control and that in several countries there is widespread anecdotal evidence, though not quantitative one, on this role of banks.

Healthy firms search around for the displaced capital of bankrupt firms but matching is imperfect and firms can end up with machines unsuitable for them. Financial intermediaries arise as internal, centralized markets where information on machines and buyers is readily available, allowing displaced capital to migrate towards its most productive uses. Financial intermediaries can perform this role by aggregating the information on firms collected in the credit market.

Intuitively, by increasing the number of highly productive matches in the credit market, intermediaries increase the share of highly productive second hand users in the decentralized resale market. This improvement in the quality of the decentralized secondary market reduces the incentive of firms to address financial intermediaries for their ability as re-deployers.

However, by increasing the number of highly productive matches in the credit market, intermediaries create also wealthy buyers without assets and contribute to decrease the thickness of the decentralized resale market. This makes the decentralized market less appealing and increases the incentive of firms to use intermediaries as resale markets. When the quality improvement in the decentralized market is not too big and the second effect prevails, better matchmaking in the credit market supports the function of intermediaries as internal markets for assets.

1.5. Financial Markets

In economics, typically, the term market means: The aggregate of possible buyers and sellers of a certain good or service and the transactions between them. The term "market" is sometimes used for what are more strictly exchanges, organizations that facilitate the trade in financial securities, e.g., a stock exchange or commodity exchange. This may be a physical location or an electronic system.

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.

- **In finance, financial markets are used to describe firms that engaged in;**
  - 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)
- Generally to match those who want capital with those who have excess capital.

UNIT TWO

FINANCIAL INSTITUTIONS IN FINANCIAL SYSTEM

Introduction

2.1 Concept and Classification of Financial Institutions.

2.1.1 Concepts of the Financial Institutions:

Financial Institutions are establishment that focuses on dealing with financial transactions, such as investments, loans and deposits. Conventionally, financial institutions are composed of organizations such as banks, trust companies, insurance companies and investment dealers. Financial institutions deal with various financial activities associated with bonds, debentures, stocks, loans, risk diversification, insurance, hedging, retirement planning, investment, portfolio management, and many other types of related functions. Almost everyone has deal with a financial

institution on a regular basis. Everything from depositing money to taking out loans and exchange currencies must be done through financial institutions.

To put it in different words, financial institutions are those organizations, which are involved in providing various types of financial services to their customers. The financial institutions are controlled and supervised by the rules and regulations delineated by government authorities. Some of the financial institutions also function as mediators in share markets and debt security markets. The principal function of financial institutions is to collect funds from the investors and direct the funds to various financial services providers in search for those funds.

With the help of their functions, the financial institutions transfer money or funds to various tiers of economy and thus play a significant role in acting upon the domestic and the international economic scenario.

For carrying out their business operations, financial institutions implement different types of economic models. They assist their clients and investors to maximize their profits by rendering appropriate guidance. Financial institutions also impart a wide range of educational programs to educate the investors on the fundamentals of investment and also regarding the valuation of stock, bonds, assets, foreign exchanges, and commodities.

As a general rule, financial institutions are engaged in what is called intermediation. Rather obviously, intermediation means acting as a go-between for two parties. The parties here are usually called lenders and borrowers or sometimes surplus sectors or units and deficit sectors or units.

On the whole what financial institutions do is to create assets for savers and liabilities for borrowers which are more attractive to each than would be the case if the parties had to deal with each other directly.

2.1.2 Classification of Financial Institutions

Private-shareholder-owned or public-government-owned organizations that, broadly speaking, act as a channel between savers and borrowers of funds (suppliers and consumers of capital). Two main types of financial institutions-with increasingly blurred dividing line, are:

1) Depository institutions such as banks and credit unions which pay interest on deposits from the interest earned on the loans, and
2) Non-depository institutions such as insurance companies and mutual funds (unit trusts) which collect funds by selling their policies or shares (units) to the public and provide returns in the form periodic benefits and profit payouts. However, if want to see the detail classification of the financial institutions the following are the main one:
   - ♥ Commercial banks;
   - ♥ Credit unions;
   - ♥ Stock brokerage firms;
   - ♥ Asset management firms;
   - ♥ Insurance companies;
   - ♥ Finance companies;
   - ♥ Building Societies; and
   - ♥ Retailers.

The various financial institutions generally act as the intermediaries between the capital market and debt market. But the service provided by financial institution depends on its type. The financial institutions are also responsible to transfer funds from investors to the companies. Typically, these are the key entities that control the flow of money in the economy. The services provided by the various types of financial institutions may vary from one institution to another.

For example:

- The services offered by the commercial banks are: insurance services, mortgages, loans and credit cards.
- The services provided by the brokerage firms, on the other hand, are different and they are - insurance, securities, mortgages, loans, credit cards, money market and check writing.
- The insurance companies offer – insurance services, securities, buying or selling service of the real estates, mortgages, loans, credit cards and check writing.
- The credit union is co-operative financial institution, which is usually controlled by the members of the union.
- The stock brokerage firms are the other types of financial institutions that help both the corporations and individuals to invest in the stock market.
- Another type of financial institution is the asset management firms. The prime functionality of these firms is to manage various securities and assets to meet the financial goals of the investors. The firms also offer fund management advice and decisions to the corporations and individuals.

On the other hand, these institutions are responsible for distributing financial resources in a planned way to the potential users. There are a number of institutions that collect and provide funds for the necessary sector or individual. Correspondingly, there are several institutions that act as the middleman and join the deficit and surplus units. Investing money on behalf of the client is another variety of functions of financial institutions.

At the same time, there are several governmental financial institutions assigned with regulatory and supervisory functions. These institutions have played a distinct role in fulfilling the financial and management needs of different industries, and have also shaped the national economic scene. Deposits taking financial organizations are known as commercial banks, mutual savings banks, savings associations, and loan associations and so on. The primary functions of financial institutions of this nature are: Accepting Deposits; Providing Commercial Loans; Providing Real Estate Loans; Providing Mortgage Loans; and Issuing Share Certificates. Finance companies provide loans, business inventory financing and indirect consumer loans. These companies get their funds by issuing bonds and other obligations.

2.2 Importance of the Financial Institutions

Financial institutions have a tremendous role up on the economic development of the country. First, on the nexus between economic growth and financial intermediation, a large body of academic research across many countries has demonstrated the important role that a highly developed banking sector and capital market have to play in facilitating economic growth. Well developed financial systems allow economies to reach their potential since they allow firms which have successfully identified profitable opportunities to exploit these opportunities as intermediaries by channeling investment funds from those in the economy who are willing to defer their consumption plans into the future.

2.2.1 Contributions of Financial Institutions for Economic Growth

In general, economic growth depends on the accumulation of input factors in the production process and on technical progress. Seeing capital and capital accumulation as an important input factor, financial development is linked most clearly to this source of growth. Financial development may also help to realize faster technical progress, embedded in the capital stock, to achieve higher economic growth. More specifically, financial development can affect growth through three main channels:

(I) It can raise the proportion of savings channeled to investment, thereby reducing the costs of financial intermediation;
(ii) It may improve the allocation of resources across investment projects, thus increasing the social marginal productivity of capital; and
(iii) It can influence the savings rates of households, for example, if it induces a higher degree of risk sharing and specialization, which as a result stimulates higher growth.

There is clear evidence of stronger growth in those countries which are characterized by a good legal structure. This may lower both information costs (e.g., through verifying the quality of disclosure of companies' accounts) as well as transaction costs (e.g., through the better legal enforcement of contracts) for a supplier of funds, such as banks.

Furthermore, when banks are allowed to be active in a wide range of activities, such as in the securities, insurance, or real estate markets, and when banks can own or control non-financial firms, or vice versa, credit may be better allocated and/or more credit may be available to entrepreneurs.

In the developed countries, the financial structure has seen a remarkable transformation and elements such as the provision of risk capital and the strengthening of market-based elements have become more important in recent years. The clearest transformation of the financial sector has been the tendency towards integration, which is leading to positive scale and scope effects and to increased competitive pressures on financial intermediaries. This is eliminating quasi-rents, improving the allocation of capital, and offering the highest possible returns and the lowest possible cost of capital. Moreover, enhanced competition among intermediaries has provided greater scope for financial innovation.

2.2.2 Important factors for stable financial system

Most generally, a stable financial system can be described as a financial system that is able to withstand shocks without giving way to cumulative processes which could impair the allocation of savings to investments and the processing of payments in the economy. How do we get there?

1. Financial system architecture should be carefully planned. Different stages of financial development require adequate institutional processes to be in place.
2. A solid micro supervision of the financial sector and individual institutions should be in place.
3. Close co-operation and exchange of information between the central bank and supervisory authorities is warranted at all times and especially in periods of financial stress.
4. There are several, complementary public policies that are typically needed to sustain or build up confidence in financial institutions.
    - ***Fiscal policy***. If fiscal authorities are restricted in their ability to run deficits or accumulate large debts, an important source of financial market stress and financial instability is removed.
    - ***Monetary policy***. As is now widely accepted, monetary authorities should in the first place try to guarantee price stability, being the best possible contribution it can make to growth in the medium to long-term. Indirectly, this should also be conducive to supporting financial stability, as the economy will have less macro uncertainties to deal with, when allocating resources.

      However, it goes without saying that the central bank should take an active interest in monitoring financial sector developments, given the importance of the sector, also from a monetary policy (transmission) perspective, and given its importance in the economic system (intermediation between lenders and borrowers). In some cases, when financial stability is threatened, monetary policy may be used as a tool to support the financial sector. This support may come not only through interest rate policy, but also and most powerfully through the central bank's role as a lender of last resort, that is, in providing final liquidity when solvent commercial banks suffer liquidity strains.

In addition, some day-to-day tools are associated with guaranteeing financial sector stability, as for example the lending and deposit facilities at the central bank providing upper and lower bounds for money market fluctuations and giving individual institutions a means to deal with end-of-day liquidity imbalances, or fine-tuning operations. Similarly, public commenting or private

persuasion of market participants can at times be used for maintaining public confidence in the banking sector.

- ***Financial supervision***. An adequate supervisory framework helps to enhance financial stability and maintain overall confidence in the financial system.
- ***A financial safety net.*** A financial safety net is in place in most countries with a view to protecting small depositors in case of a bank failure. This system seems to work relatively well in maintaining confidence in financial institutions.
- ***Market discipline***. Of course, a stable financial system cannot operate without market discipline of the financial sector. In order to avoid costly bank runs and bank failures, the sector must show some self-discipline, to meet acceptable standards and expectations of shareholders. Banks should be able to show good performance, adopt a sound risk management system and adhere to adequate corporate governance rules. In case of deteriorating results, prompt corrective actions should be taken and announced to the public, in order not to lose its credibility. As an external watchdog, rating agencies provide a valuable service by monitoring the financial sector and designing a rating system, which reflect the institution's capacity to service its debts. This has, at times, proven to be a valuable tool to distinguish sound from unhealthy institutions.

2.3 Depository Financial Institutions

A depository financial institution is one that specializes in depository lending, and the services offered by these institutions are a bit different from that of other financial service providers. The depository financial institutions are also known as deposit-taking financial organizations.

The primary functions of these institutions are to accept deposits and to use the money collected for lending purposes. They raise loadable funds by selling deposits to the public or in other words they are those institutions whose funds come significantly from customer deposits. They accept deposits from individuals and firms and use these funds to participate in the debt market, making loans or purchasing other debt instruments such as Treasury bills. The lending activities of depository financial institutions basically include channelizing funds for mortgage loans, commercial loans and real estate loans.

> A depository institution is a financial institution such as a savings bank, commercial bank, savings and loan association, or credit union that is legally allowed to accept monetary deposits from consumers.

The major assets of depository institutions are loans (financial assets) and reported on the left hand side of the balance sheet. The major liabilities

(sources of funds) of depository institutions are deposits and are presented on the right hand side of the balance sheet.

Depository institutions can also be generally categorized in to commercial banks and other depository institutions (such as saving and loan institutions, credit unions, and microfinance institutions).

- **Depository institutions are popular financial institutions for the following reasons:**
  1. They offer deposit accounts that can accommodate the amount and liquidity characteristics desired by most surplus units.
  2. They repackage funds received from deposits to provide loans of the size & maturity desired by deficit units.
  3. They accept the risk on loans provided.
  4. They have more expertise than individual surplus units in evaluating the credit worthiness of deficit units.
  5. They diversify their loans among numerous deficit units and therefore can absorb defaulted loans better than individual surplus units could.

When a depository institution offers a loan, it is acting as a creditor, just as if it had purchased a debt security. Yet, the more personalized loan agreement is less marketable in the secondary market than a debt security, because detailed provisions on a loan can differ significantly among loans. Any potential investors would need to review all provisions before purchasing loans in the secondary market.

2.3.2 Other Depository Institutions

When banking or, other depository financial institutions temporarily break down or operate ineffectively, the ability of firms to obtain funds necessary for continuing existing projects and pursuing new endeavors is curtailed. Severe disruptions in the intermediation process can even lead to financial crises and, in some cases, undo years of economic and social progress. The importance of depository institutions for economic growth coupled with their fragility has led governments to establish official agencies to regulate and supervise them.

The common goals for these agencies are to promote the development of the modern financial systems that

(a) avoid excessive fragility and

(b) efficiently intermediate between savers and borrowers.

- ***The following are among the other depository institutions (in addition to banks) which play significant role in the economic and financial system of every country.***

2.3.2.1 Savings and Loans Associations

A savings and loan association (or S&L), also known as a thrift, is a financial institution that specializes in accepting savings deposits and making mortgage and other loans. They are often mutually held (often called mutual savings banks), meaning that the depositors and borrowers are members with voting rights and have the ability to direct the financial and managerial goals of the organization. It is possible for a savings and loan to be stock-based and even publicly traded. This means, however, that it truly no longer is an association and depositors and borrowers no longer have any managerial control.

Savings and loans associations (S&Ls) were originally designed as mutual associations, (i.e., owned by depositors) to convert funds from savings accounts into mortgage loans. They are the predominant home mortgage lender in many countries, making loans to finance the purchase of housing for individuals and families. The purpose is to ensure a market for financing housing loans. Today, the distinction between S&Ls and commercial banks is minimal. However, S &Ls continue to hold a less diversified set of assets than commercial banks do. S and Ls accept deposit and extend loans primarily to household customers.

> S and Ls emphasize on longer-term loans to households in contrast of most other deposit type financial institutions. Many S and Ls are mutual and therefore have no stockholders but owned by depositors.

Savings and loan associations can be either state or federally chartered and must fulfill the state requirements to be incorporated. Incorporation is based on state law, and the articles of incorporation must clearly define the organizational structure, the rights of members, and the relationship between the stockholders and the association. In order to convert from state to a federal corporation, savings and loan associations must comply with the laws of the state. The stockholders of the corporation are the members of the savings and loan association who share profits and also have the right to partake in the management of the association. As members, liability of stockholders is equivalent only to their individual stock interest and as such they are not personally liable for negligence or debts of the savings and loan associations.

The day-to-day affairs of the association are controlled by the officers and directors whose job responsibilities include organizing and operating the association in compliance with the state and federal laws. Thus, they are accountable for breaches of these common-law duties that may occur due to violation of state or federal laws or corporation bylaws. They are also responsible for selecting competent staff for managing affairs of the

association, devise operating policies, monitor operations, and assess audit reports.

Savings and loans can no longer afford to remain mere mortgage providers with their margins narrowing down as higher interest rates continue to inflate borrowing costs. At the same time, growing competition has impacted the lending rates making it impossible for S&Ls to reap the same level of profits they used to make earlier. In order to offer substantial profits to their shareholders, S&Ls today choose to imitate other banks and offer commercial and automobile loans along with a host of other banking services and products such as mutual funds, checking and loans. Thus, it will be increasingly difficult to distinguish S&Ls from conventional banks due to this gradual transition from thrift to bank-like institutions.

- **The characteristics of savings and loan associations**

The savings and loan association became a strong force in the early 20th century through assisting people with home ownership, through mortgage lending, and further assisting their members with basic saving and investing outlets, typically through passbook savings accounts and term certificates of deposit. The most important purpose of these institutions is to make mortgage loans on residential property. These organizations, which also are known as savings associations, building and loan associations, cooperative banks and homestead associations, are the primary source of financial assistance to a large segment of many countries homeowners.

As home-financing institutions, they give primary attention to single-family residences and are equipped to make loans in this area. Some of the most important characteristics of a savings and loan association are:

1. It is generally a locally owned and privately managed home financing institution.
2. It receives individuals' savings and uses these funds to make long-term amortized loans to home purchasers.
3. It makes loans for the construction, purchase, repair, or refinancing of houses.
4. It is state or federal chartered.

2.3.2.2 **Credit Unions**

A credit union is a member-owned financial cooperative, democratically controlled by its members, and operated for the purpose of promoting thrift, providing credit at competitive rates, and providing other financial services to its members. They are house hold oriented intermediaries, offering deposit and credit services to individuals and families. They are cooperative, self-help association of individuals rather than profit motivated institutions accepting deposits from and making loans to their members, all of whom have a common bond, such as working for the same employer. They offer low loan rates and

high deposit interest rates and have relatively low operating costs. The members of a credit union are owners receiving dividends and sharing in any losses that occur.

Credit Unions usually report low default and delinquency rates and organized around a common affiliate.

Many credit unions also provide services intended to support community development or sustainable international development on a local level, and could be considered community development financial institutions. They are organized as cooperative depository institutions, much like mutual savings banks. Depositors are credited with purchasing shares in the cooperative, which they own and operate. Like savings and loans. Credit unions were originally restricted by law to accepting savings deposits and making consumer loans. Recent regulatory changes allow them to accept checkable deposits and make a broader array of loans.

Worldwide, credit union systems vary significantly in terms of total system assets and average institution asset size, ranging from volunteer operations with a handful of members to institutions with several billion dollars in assets and hundreds of thousands of members. Credit union policies governing interest rates and other matters are set by a volunteer Board of Directors elected by and from the membership itself.

Only a member of a credit union may deposit money with the credit union, or borrow money from it. As such, credit unions have historically marketed themselves as providing superior member service and being committed to helping members improve their financial health.

Credit unions typically pay higher dividend (interest) rates on shares (deposits) and charge lower interest on loans than banks.

Credit union revenues (from loans and investments) do, however, need to exceed operating expenses and dividends (interest paid on deposits) in order to maintain capital and solvency. Often credit unions have a lower cost of funds than typical commercial banks, due to a higher proportion of non/low interest bearing deposits. Credit unions offer many of the same financial services as banks, often using a different terminology. Common services include: share accounts (savings accounts), share draft (checking) accounts, credit cards, share term certificates (certificates of deposit), and online banking.

Credit unions, in the very beginning, were not-for-profit cooperative financial institutions created by people with a common affiliation, such as belonging to a labor union, an association, or even working or living in the same place. They were designed to benefit people who were not being served by banks, such as those who were not approved for bank loans. Today, however, credit unions have become widespread. They are able to beat banks in nearly all categories of loan interest rates because they're nonprofit and as a result doesn't have to pay taxes.

- **The following are some the unique characteristics of a credit union:**
  1. **Nonprofit status:** For-profit banks and other lending institutions are looking for a return on an investment when a member takes out a loan. Credit unions, however, have no stockholders looking at the return on their investment.
  2. **Democratic process:** The board of directors is elected by the union's membership and works on a volunteer basis. Unlike banks, credit union members have a direct say in who's elected to run the credit union.
  3. **Inclusiveness:** Credit unions have long-standing reputations for allowing spouses, siblings, and children of members to join.
  4. **Lower fees:** Comparatively, credit unions have lower fees for services than banks.
  5. **Better interest rates on loans:** Interest rates are typically better through credit unions, which traditionally have been among the leaders in auto loans.
  6. **Funds returned to members:** If there are excess funds, they are generally returned to the members in the form of dividends.
  7. **Easy to join:** You need only ask your employer, family members, or neighbors about credit unions that they may be part of. The process is then fairly simple, and minimum balances are usually very low.

Credit Unions and Banks

The major difference between the credit unions and banks is that the credit unions are owned by the members unlike banks. The policies of credit unions are governed by a volunteer Board of Directors that is elected by and from the membership itself. This board of directors also decides on the interest rates to be charged. According to the regulation of credit unions, only the members of the credit union are eligible to deposit money in the union or borrow money from the union.

Since they are the co-operative financial institutions that are owned by the members of the union, the credit unions are always committed and dedicated to the members and ensure to improve the financial status of the members. The credit unions also offer several financial services like banks, but the terminology used here are different from the banks.

> The credit unions offer the services of share accounts, share draft accounts, share term certificates, credit cards and online banking services.

Even if they are generally non-profit organizations, the credit unions can perform to earn profit for their members. The profits earned by the union are received by the members in the forms of dividends. The dividends are paid on savings that are taxed as ordinary income.

Depending on the financial structure of the country, the functionality of credit unions may vary in different countries. Due to their status as not-for-profit financial institutions, credit unions in some countries are exempt from federal and state income taxes (but, not from employment or property taxes,). Additionally, credit union members pay income taxes on dividends earned through financial participation in the credit union; this is similar to the taxation structure enjoyed by many banks.

Bank holding companies and their affiliates aggressively compete to provide services to credit unions through their ATM networks, corporate checking accounts, and certificate of deposit programs. Credit unions maintain that no matter their size or field of membership, the fact that they are owned by their members and not share holders makes them fundamentally different from banks. The size of the credit unions may vary in a large manner. There are credits unions available both with handful of members to thousands of members.

2.3.2.3 Micro-Finance Institutions

Microfinance is usually understood to entail the provision of financial services to micro-entrepreneurs and small businesses, which lack access to banking and related services due to the high transaction costs associated with serving these client categories. Micro finance is defined as the provision of financial intermediation through distribution of small loans acceptance of small savings and the provision of other financial products and services to the poor. A micro finance institution (MFI) is an organization that offers financial services to the very poor. They are making small loans available to the poor through schemes specially designed to meet the Poor's particular needs and circumstances.

> The main focus of micro financing is on the poor through provision of small credit and acceptance of small savings.

- ***The two main mechanisms for the delivery of financial services to such clients are:***
  (1) Relationship-based banking for individual entrepreneurs and small businesses;
  (2) Group-based models, where several entrepreneurs come together to apply for loans and other services as a group.

In some countries microfinance is used to describe the supply of financial services to low-income employees, which, however, is closer to the retail finance model prevalent in mainstream banking. It is considered as a movement whose object is a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers. Many of those who promote microfinance generally believe that such access will help poor people out of poverty. For others, microfinance is a way to promote economic development, employment and growth through the support of micro-entrepreneurs and small businesses.

Microfinance is a broad category of services, which includes microcredit. Microcredit is provision of credit services to poor clients. Although microcredit is one of the aspects of microfinance, conflation of the two terms is endemic in public discourse. Critics often attack microcredit while referring to it indiscriminately as either 'microcredit' or 'microfinance'.

In general, the typical client base of any micro-finance institution is poor people who don't have access to formal financial institutions.

Micro-finance clients are typically self-employed, entrepreneurs. In rural areas, they are usually small farmers and others who are engaged in small income generating activities such as food processing and petty trade. In urban areas, micro-finance activities are more diverse and include shopkeepers, service providers, artisans, street vendors, etc.

- **The Distinguishing characteristics of micro finance from Conventional Banks**

The most distinguishing characteristics of MFIs from the conventional banks are:

1. Procedures are designed to be helpful to the client and therefore are user friendly. They are simple to understand, locally provided and easily and quickly accessible.
2. The traditional lender's requirement for physical collateral (such as land, house and productive assets) is usually replaced by system of

collective guarantee groups whose members are mutually responsible for ensuring individual loans are repaid. Loans are dependent not only on individual's repayment performance, but also on that of every other group members.

3. Loan amounts especially at the first loan cycle are too small, much smaller than the traditional banks would find it viable to provide service.

4. Borrowers are usually required to be savers.

5. Together with their long term sustainability they have the objective of ending poverty and

6. MFI's operating costs as well as administrative cost per loan are higher than the conventional banks.

2.3.2.4 Mutual Savings Banks

A mutual savings bank is a financial institution chartered by a central or regional government, without capital stock, that is owned by its members who subscribe to a common fund. From this fund claims, loans, etc., are paid. Profits after deductions are shared between the members. The institution is intended to provide a safe place for individual members to save and to invest those savings in mortgages, loans, stocks, bonds and other securities and to share in any profits or losses that result. The members own the business.

Mutual savings banks are much like savings and loans, but are owned cooperatively by members with a common interest, such as company employees, union members, or congregation members.

> A mutual savings bank is one conducted wholly for the benefit of the depositors, who receive in the form of interest all profits over and above necessary expenses and a moderate part of the profits set aside in a surplus fund to provide for unexpected losses or contingencies.

Mutual savings banks were designed to stimulate savings by individuals; the exclusive function of these banks is to protect deposits, make limited, secure investments, and provide depositors with interest. Saving banks play an active role in the residential mortgage banks but are more diversified in their investments, purchasing corporate bonds and common stocks, making customer loans and investing in commercial mortgage banks. Saving banks are owned by their depositors to which all earnings not retained are paid as owner’s dividend. Mortgage and Mortgage related instruments are principal assets followed by investments in non-mortgage loans, corporate bonds, corporate stocks and government bonds.

Unlike commercial banks, savings banks have no stockholders; the entirety of profits beyond the upkeep of the bank belongs to the depositors of the mutual savings bank. Mutual savings banks prioritize security, and as a result, have historically been characteristically conservative in their investments. This conservatism is what allowed mutual savings banks to remain stable throughout the turbulent period of the great depression, despite the failing of commercial banks and savings and loan associations.

➧ ***In general, it is a financial institution chartered by state or federal government to:***

(1) Provide a safe place for individuals to save and
(2) Invest those savings in mortgages loans, stocks, bonds and other securities.

A mutual savings bank does not issue capital stock. Profits are distributed to the owner/customers in proportion to the business they do with the institution.

2.4 Non-depository Institutions

Government or private organization (such as building society, insurance company, investment trust, or mutual fund or unit trust) that serves as an intermediary between savers and borrowers, but does not accept time deposits. Such institutions fund their lending activities either by selling securities (bonds, notes, stock/shares) or insurance policies to the public. Their liabilities (depending on the liquidity of the liability) may fall under one or more money supply definitions, or may be classified as near money.

Unlike depository institutions, non-depository institutions do not accept checkable deposits. With one exception that will be noted shortly, you cannot simply write a "check" to withdraw funds from a non-depository institution.

- **Types and Role of Non-depository Financial Institutions**

Non-depository institutions serve various functions in financial markets, ranging from financial intermediation to selling insurance against risk. The following are some of the types of non-depository financial institutions with their role in the financial system.

2.4.1 Financial-Brokers

A brokerage firm, or simply brokerage, is a financial institution that facilitates the buying and selling of financial securities between a buyer and a seller. Brokerage firms serve a clientele of investors who trade public stocks and other securities, usually through the firm's agent stockbrokers. A traditional, or "full service", brokerage firm usually undertakes more than simply carrying out a stock or bond trade. The staff of this type of brokerage firm is entrusted with the responsibility of researching the markets to provide appropriate recommendations and in so doing; they direct the actions of pension fund

managers and portfolio managers alike. These firms also offer margin loans for certain approved clients to purchase investments on credit, subject to agreed terms and conditions. Traditional brokerage firms have also become a source of up-to-date stock prices and quotes.

A finance broker is a type of commercial broker that assists clients in evaluating their current financing needs and identifying the best way to meet those needs.

This often involves investigating a wide range of lending opportunities and then assisting the customer in applying for and ultimately securing the best financing option available. A finance broker may specialize in a particular lending area such as mortgage loans or provide access to a wide range of different types of business finance options.

There are a number of specific finance options that call for a specialized finance broker. A floor broker serves as the representative of a client to transaction purchases and sales on a stock market directly on the market floor. An upstairs broker tends to focus more on retail markets and similar transactions. A mortgage broker will seek to identify and secure the best mortgage deals for clients. While many brokers do choose to specialize in one or two areas, it is possible to find a finance broker that offers a one stop shopping solution for a variety of business financing needs.

One of the advantages of using the services of a financial broker is that this type of commissioned broker will have access to loan options and other financial solutions that may or may not be easily identified by a borrower.

Because the broker has a vested interest in assisting the client in securing financing, he or she often will investigate traditional and non-traditional loan options to find the best solution for the client. This ability to tap into such a wide network of resources often leads to the securing of a loan even when the client has been turned down by numerous bankers and other lenders.
Along with work in acting as an intermediary to secure loans, a finance broker can also assist customers with leasing and purchase projects. As with loans, the broker is likely to be able to tap into broad networks that will yield purchase and lease opportunities that the client could possibly overlook or never identify in the first place.

Functioning as an advocate or finance agent for the customer, the broker will pursue options that work well with the operating budget of the client and often save customers a great deal of money, even after the broker's commission is taken into consideration.

The finance broker does all the legwork for the client. This can mean considerable savings on time and effort in order to find and secure the right business arrangement. Since even large corporations normally have limited amounts of both resources, engaging the services of a finance broker only makes sense!

A discount broker or an online broker is a firm that charges a relatively small commission by having its clients perform trades via automated, computerized trading systems rather than by having an actual stockbroker assist with the trade. Most traditional brokerage firms offer discount options and compete heavily for client volume due to a shift towards this method of trading. Other ways to lower costs for these brokers is by executing orders only a few times a day by aggregating orders from a large number of small investors into one or more block trades which are made at certain specific times during the day.

➧ **They help lower costs in two ways*:***

1) By matching buy and sell orders within the firm's order book the overall quantity of stock to be traded can be reduced thus reducing commissions.
2) The broker can split the bid-ask spread with the investor when matching buy and sell orders - a win-win situation in most cases

Since investor money is pooled before stocks are bought or sold, it enables investors to contribute small amounts of cash using which fractional shares of specific stocks can be purchased. This is usually not possible with a regular stockbroker. In general, brokerage houses or firms: buy/sell old securities on behalf of individuals. Brokerage firms serve the valuable function of linking buyers and sellers of financial assets. In this regard, they function as intermediaries, earning a fee for each transaction they create.

Modern brokerage firms compete with depository institutions in the deposit market, where they attract depositors with money market mutual funds. Nonetheless, brokerage firms are not formally considered depository institutions because their main function is to serve as brokers in the secondary debt and equity markets.

2.4.2 Investment Institutions

1) **Finance Companies**: are sometimes called department stores of consumer and business credit. They grant credit to businesses and consumers for a wide variety of purposes acquiring their funds mainly from debt. Like banks, they use people's savings to make loans to businesses, but instead of holding deposits, they sell bonds and commercial papers.

➧ **Types of finance companies:**

a) ***Consumer Finance companies***-make personal cash loans to individuals.
b) ***Sales Finance Companies-*** make indirect loans to consumers by purchasing installment paper from dealers selling automobiles and other consumer durables.
c) ***Commercial Finance Companies***- focus primarily on extending credit to business firms.
d) Other Financial Institutions:

ii. ***Security Dealers*** are firms that take a position of risk in government and privately issued securities, purchasing the instruments from sellers and reselling them to buyers with the expectation of a profitable spread between purchases and sales.
iii. ***Investment Banks*** are capital market firms that assist businesses and governments to issue debt and stock in order to raise new capital.
iv. ***Mortgage Banks*** are intermediaries that work with other businesses or real estate development projects and sell the mortgage loan instruments to other investors.
v. ***Venture Capital Firms*** are institutional investors that provide long-term capital financing for new businesses and rapidly emerging companies.
vi. ***Real Estate Investment Trusts*** are specialized lenders and equity investors that finance commercial and residential projects.
vii. ***Leasing Companies*** are financial firms that purchase business equipment and other productive assets and make the purchased items available for use by others in return for rental fee.

2) ***Investment companies:*** provide an outlet for the savings of many individual investors towards bonds, stocks, and money market securities. Most investment companies stocks are highly liquid because they repurchase their outstanding shares at current market price.

3) ***Mutual funds:*** are especially attractive to small investor, which purchase shares of these funds and gain greater diversification, risk sharing, lower transaction cost, opportunities for capital gains and indirect access to higher yielding securities that can be purchased only in large blocks. They pool funds of savers and make them available to business and government demanders.

They obtain funds through sale of shares and uses proceeds to acquire bonds and stocks issued by various business and government units. They create a diversified and professionally managed portfolio of securities to achieve a specified investment objective, such as liquidity with high return. Some mutual funds, called money market mutual funds, invest in short-term, safe assets like Treasury bills and large bank certificates of deposit.

Largely for historical reasons money market mutual funds are not considered depository institutions even though shareholders are often allowed to write checks on their accounts.

2.4.3 Pension Funds

A pension fund is an entity set up to collect monies from employer(s) and workers, invest the proceeds in securities and other assets, and pay benefits to retirees from the fund's accumulated resources. It is a pool of assets forming an independent legal entity that are bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. Pension funds are savings plan through which fund participants accumulate savings during their working days so that they withdraw the fund during their retirement years.

It is a fund established by an employer to facilitate and organize the investment of employees' retirement funds contributed by the employer and employees. The pension fund is a common asset pool meant to generate stable growth over the long term, and provide pensions for employees when they reach the end of their working years and commence retirement.

A pension plan is a promise by a pension plan sponsor to a plan member to provide a pension upon retirement. The sponsor may be a company, an employer, a union or a jointly trustee plan where both management and unions in an industry appoint trustees to a board which manages the plan. This promise is legally stated in the "pension plan document" which states the provisions for the plan. Pension plans may be regulated by governments or financial institutions.

A pension fund ordinarily has an investment policy statement that describes the nature of the assets in which the pension fund can invest A trustee is appointed to hold the assets in trust for the benefit of the plan members. Usually the trustee is also the custodian, which holds the plan investments. Pension plans usually hire an outside investment manager to invest the plan assets. The sponsor may also appoint an "investment consultant" to advice on investment issues and help select and assess the performance of investment managers.

Pension funds are commonly run by some sort of financial intermediary for the company and its employees, although some larger corporations operate their pension funds in-house. Pension funds control relatively large amounts of capital and represent the largest institutional investors in many nations.

Traditionally, the investment plan of a pension fund has been quite conservative, sometimes limiting its investment vehicles to government bonds or life insurance annuities. In recent decades, the average pension fund has

assumed a more aggressive investment posture to achieve the higher returns required by its obligations.

Because of its huge resources, a pension fund may have considerable clout in the investment community and use its influence to achieve social goals. In other cases, however, a pension fund will work only to achieve the highest returns possible for its retiree beneficiaries.

➧ Basic characteristics of Pension Trust Fund

Every organization maintains a pension trust fund for its employees and protects liabilities of misappropriation and mishandling of pension funds. A pension plan is a fund that is established by private employers, governments, or unions for the payment of retirement benefits. Pension plans have grown rapidly largely because of favorable tax treatment. Qualified pension funds are exempt from federal income taxes, as are employer contributions. The two types of pension funds are defined contribution plans and defined benefit plans. In the former plan the sponsor is responsible only for making specified contributions into the plan on behalf of qualifying employees but does not guarantee any specific amount at retirement. A defined benefit plan sponsor agrees to make specified payments to qualifying employees at retirement.

> A pension trust fund is a fund that is made up of money which is contributed to by the employer and the employee for pension benefits.

Since the funds flowing in are not demand deposits, you cannot write a check against your balance in a pension fund. Like life insurance companies, these institutions can accurately predict payouts and hence can hold long-term assets. They hold portfolios consisting mostly of stocks and bonds. The returns on these assets are paid out to participating individuals when reach retirement age. Sponsors of pension plans can agree to various types of pension obligations to the beneficiaries of the plan.

There are plans where retirement benefits depend on the participant's income for a specified number of years before retirement and the total number of years the participant worked. This will affect the amount of the cash outlay. The timing of the cash outlay depends on when the employee elects to retire, and whether the employee remains with the sponsoring plan until retirement. Moreover, both the amount and the timing will depend on how the employee elects to have payments made over only the employee's life or those of the employee and spouse. Pension plans are usually considered "patient capital" because of their long time horizon.

The types of investments undertaken by a pension fund depend on its objectives and constraints which are provided for in its "investment policy statement". Legislation demands a "prudent approach" of diversifying risk across a number of securities or asset types. Taking prudence into account, pension funds strive to achieve the highest practical return which lowers the cost of their pension "obligation" considerably.

✪ ***The responsibilities of an appointed trustee include:***

- ♥ Administering the funds;
- ♥ Investing the money;
- ♥ Collecting the earnings and interest; and
- ♥ Distributing the benefits.

A pension fund that doesn't have enough investment to cover its pension obligations is said to be "under-funded" or have a "shortfall" in invested assets and companies are required to make this up through higher contributions.

A pension fund that has more investments than necessary to cover its pension obligation is called "over-funded" or said to have a pension "surplus". Companies with a pension surplus can reduce or suspend their contributions altogether. The major limiting factor to putting a company's entire pension fund in very high return and "risky" assets is the financial condition of the pension fund.

🡻 ***The financial condition of a pension plan depends on a number of factors, including:***

The demographic characteristics of the plan members very much dictate the time horizon for investment. If the plan sponsor is a new company with relatively young employees, the eventual pensions are very far in the future. This means if the value of the plan investments fluctuates considerably, there will not be a need for funds to be withdrawn at a low point when the investments' value is down considerably. A "young plan" can have a high weighting in riskier or more illiquid assets such as stocks, real estate and non-traditional investments. This is in contrast to a "mature plan" which has much older participants and actually is paying pensions to many retirees. The investments of these plans usually are much more towards fixed income securities such as bonds and mortgages which fluctuate much less in price and provide a stable income source to pay pensions regularly.

The financial state of the company itself is important. If a company is in a difficult financial situation, it will be more difficult to make large contributions to the pension fund to make up potential shortfalls from investment performance. This usually results in a more capital risk averse approach and higher fixed income weighting.

- **The historical investment performance** of the fund's investments results in the amount of assets available at any point. A plan with poor historical investment performance will have generated a much lower rate of return and therefore will have less funds on hand to provide for pension obligations. Perversely, a "conservative" investment approach with a low equity weighting will result in low returns which might lower the future risk tolerance of a plan.

The biggest drawback of a pension trust fund and company pensions in general, is that many such plans guarantee to pay a certain level of pension, often based on the employee's salary upon retirement.

This is in contrast to most private plans, where the pension depends on how well investments perform. This creates the risk that a pension trust fund may not have enough money to pay the guaranteed pensions if investments do not go as well as planned. In some cases, the set-up of a pension trust fund relies on the money invested by current employees to provide the pensions of people who have retired. This can be problematic if demographic changes, such as the “baby boomers” reaching retirement age, create an imbalance between employees and retirees.

2.4.4 Insurance Companies

We assume most people are risk-averse. That is, most people are prepared to make a payment (or sacrifice some income) in order to avoid uncertainty, especially if the uncertainty mean possibility of a serious loss.
Amongst the non-deposit taking institutions this service is carried out by insurance companies. They allow people to choose the certainty of a slightly reduced current income (reduced by the premiums they pay) in exchange for avoiding a catastrophic loss of income (or wealth) if some accident should occur.

Insurance is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss. Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for payment.

An insurer, or insurance carrier, is a company selling the insurance; the insured, or policyholder, is the person or entity buying the insurance policy. The amount to be charged for a certain amount of insurance coverage is called the premium. Risk management, the practice of appraising and controlling risk, has evolved as a discrete field of study and practice. The transaction involves the insured assuming a guaranteed and known relatively small loss in

the form of payment to the insurer in exchange for the insurer's promise to compensate (indemnify) the insured in the case of a financial (personal) loss. The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insured will be financially compensated.

The basic purpose of insurance is to protect against loss. Insurance companies, which date back to 17th century protect against their customers' possible losses by agreeing to pay a specified amount of money when a loss occur, in exchange for the customer's payment of a regular amount of money, known as a "premium."

Insurance began in the European shipping industry as a way to protect both merchants and ship owners from loss. At the time, shipping by sea was the fastest way to transport goods, but it was also dangerous, and ships and their cargo were frequently lost. Merchants and ship owners tried to protect themselves against these losses by contracting with insurers, who agreed to pay a specified amount of money to the merchant or ship owner if the goods or ship were lost.

Insurance companies sell protection against loss, and that protection is embodied in an insurance policy. An insurance policy is a legal contract. It spells out in detail exactly what the insurance company will agree to pay and for which types of losses. In exchange, the customer agrees to pay a certain amount of money, known as a premium. Premiums are usually paid monthly, but may be paid quarterly or yearly.

Usually, the role of an insurance company under an insurance contract is to pay for losses associated with certain events. For example, a car insurance policy requires the insurance company to pay a specified sum if the customer is in a car accident. Usually, a customer is required to notify the insurance company of a loss, or "file a claim," in order to receive insurance payment.

The dollar amount of premiums a customer pays on an insurance contract and the amount the insurance company agrees to pay if a loss occurs are based on costs calculated by the insurance company. Insurance companies play a large role in compiling statistics on accidents, health issues, and life expectancies, because they use this data to set rates for different types of insurance.

For most insurance policies, the amount of the premium a customer pays is very small compared to the amount of money the insurance company promises to pay if a loss occurs. This is true even when a customer has paid premiums for many years. Insurance companies can charge low premiums relative to promised loss payments because insurance companies offer the same coverage to many different people or businesses and uses the premiums paid by all of them to pay if any one of them incurs a loss. This is known as "spreading risk"; the customers are generally known as the "risk pool."

Insurance companies try to insure that the risk pool contains a good mix of low-risk and high-risk individuals.

Many insurance companies are for-profit institutions. As for-profit businesses, these insurance companies are also expected to make money that is distributed to their shareholders. Profit margins therefore figure into many decisions a for-profit insurance company makes.
Non-profit and mutual insurance companies also exist. Unlike their for-profit cousins, these insurance companies use any profits they make to offer lower premiums to customers or to provide greater coverage.

Accordingly, there are several types of insurance companies. Each one may serve a company's insurance needs very well, but there are significant differences between them that a company should be aware of before purchasing an insurance contract. The types of insurance companies include:

Captive insurance company, which is a stock insurance company that is formed to underwrite the risks of its parent company or in some, cases a sponsoring group or association. Mutual is also is a company in which each policy holder is an owner, and where earnings are distributed as dividends. If a net loss results, policyholders may be subject to extra assessments. In most cases, however, non-assessable policies are issued.

Reciprocal organization is an association of insured companies that is independently operated by a manager. Advance deposits are made, against which are charged the proportionate costs of operations. Stock company can have an insurance company that behaves like a normal corporation – earnings not retained in the business are distributed to shareholders as dividends and not to policyholders.

Another way to categorize insurance companies is by the type of service offered. For example, a monoline company provides only one type of insurance coverage, while a multiple line company provides more than one kind of insurance. A financial services company provides not only insurance but also financial services to customers.

A company can also use self-insurance when it deliberately plans to cover losses from its own resources rather than through those of an insurer. It can be appropriate in any of the following cases:

- ✓ When the administrative loss of using an insurer exceeds the amount of the loss.
- ✓ When a company has sufficient excess resources available to cover even the largest claim.
- ✓ When excessive premium payments are the only alternative.
- ✓ When insurance is not available at any price.

A form of partial self-insurance is to use large deductibles on insurance policies, so that a company pays for all but the very largest claims.

Finally, a company can create a captive insurer that provides insurance to the parent company. Captive insurers can provide coverage that is tailored to the parent organization, and can provide less dependence on the vagaries of the commercial insurance market. A variation on the captive insurer concept is a fronting program, in which a parent company buys insurance from an independent insurance company, which then reinsures the exposure with a captive of the parent company. This technique is used to avoid licensing the captive insurer in every state where the parent company does business, though the captive insurer must still be authorized to accept reinsurance. Fronting also allows the parent company to obtain local service from the independent insurance company while shifting the exposure to the captive company. In whatever form the self-insurance may take, the risk manager should work with the controller to determine the amount of loss reserves to set aside to pay for claims as they arise.

In some states, a company can become a self-insurer for workers' compensation. To do this, a company must qualify under state law as a self-insurer, purchase umbrella coverage to guard against catastrophic claims, post a surety bond, and create a claims administration department to handle claims. The advantages of doing this are lower costs (by eliminating the insurer's profit) and better cash flow (because there are no up-front insurance payments). The disadvantages of this approach are extra administrative costs as well as the cost of qualifying the company in each state in which the company operates. These are some of the variations that a company can consider when purchasing insurance, either through a third party, a controlled subsidiary, or by providing its own coverage.

2.4.5 Investment Banking Firms

An investment bank is a financial institution that assists individuals, corporations and governments in raising capital by underwriting and/or acting as the client's agent in the issuance of securities. An investment bank may also assist companies involved in mergers and acquisitions, and provide ancillary services such as market making, trading of derivatives, fixed income instruments, foreign exchange, commodities, and equity securities.

Unlike commercial banks and retail banks, investment banks do not take deposits. Investment banking firms provide their clients with the opportunity to generate funds through different processes.

At the same time, they also provide professional services to the investors for identifying different investment opportunities and to invest in the same. The investment banking firms provide various financial services to a wide range of clients. There are both institutional as well as individual clients of these firms. At the

same time, these firms also offer a number of services to different national governments.

There are two main lines of business in investment banking. Trading securities for cash or for other securities (i.e., facilitating transactions, market-making), or the promotion of securities (i.e., underwriting, research, etc.) is the "sell side", while dealing with pension funds, mutual funds, hedge funds, and the investing public (who consume the products and services of the sell-side in order to maximize their return on investment) constitutes the "buy side". Many firms have buy and sell side components.

An investment bank can also be split into private and public functions with an information barrier which separates the two to prevent information from crossing. The private areas of the bank deal with private insider information that may not be publicly disclosed, while the public areas such as stock analysis deal with public information.

⇒ Benefits of Investment Banking Firms

The investment banking firms play an important role in creating customized strategies for business activities. The investment banking services are also available for the activities like divestitures, restructurings, buyouts and others. All these activities need huge amount of money and the investment banking firms are responsible for arranging these funds. At the same time, there are individual clients of investment banking firms. These clients are helped in a number of ways. The firms help the clients to identify the growth prospect of different investment options and to invest in the best one.

The clients of the investment banking firms are provided with advisory services. The firms also offer a range of capital raising opportunities to the clients. They help the clients to place their equities in such a manner that they can produce highest yields. At the same time, the firms are also involved in the syndication of primary market on behalf of their clients. The investment banking firms also play a major role in arranging debt securities for their clients. The corporate clients of the companies are offered with several other services as well. The mergers and acquisitions are a very important part of the business expansion plans.

⇒ Core Investment Banking Activities and their development

Investment banking is one of the most global industries and is hence continuously challenged to respond to new developments and innovation in the global financial markets. New products with higher margins are constantly invented and manufactured by bankers in the hope of winning over clients and developing trading know-how in new markets.

For example, trading bonds and equities for customers is now a commodity business, but structuring and trading derivatives retains higher margins in

good times—and the risk of large losses in difficult market conditions, such as the credit crunch that began in 2007. Each over-the-counter contract has to be uniquely structured and could involve complex pay-off and risk profiles. Listed option contracts are traded through major exchanges, and are almost as commoditized as general equity securities.

In addition, while many products have been commoditized, an increasing amount of profit within investment banks has come from proprietary trading, where size creates a positive network benefit (since the more trades an investment bank does, the more it knows about the market flow, allowing it to theoretically make better trades and pass on better guidance to clients).

The fastest growing segments of the investment banking industry are private investments into public companies. Such transactions are privately negotiated between companies and accredited investors. Another development in recent years has been the vertical integration of debt securitization. Previously, investment banks had assisted lenders in raising more lending funds and having the ability to offer longer term fixed interest rates by converting lenders' outstanding loans into bonds.

For example, a mortgage lender would make a house loan, and then use the investment bank to sell bonds to fund the debt; the money from the sale of the bonds can be used to make new loans, while the lender accepts loan payments and passes the payments on to the bondholders. This process is called securitization.

However, lenders have begun to securitize loans themselves, especially in the areas of mortgage loans. Because of this, and because of the fear that this will continue, many investment banks have focused on becoming lenders themselves, making loans with the goal of securitizing them. In fact, in the areas of commercial mortgages, many investment banks lend at loss leader interest rates in order to make money securitizing the loans, causing them to be a very popular financing option for commercial property investors and developers. Securitized house loans may have exacerbated the subprime mortgage crisis beginning in 2007, by making risky loans less apparent to investors.

Investment banks offer services to both corporations issuing securities and investors buying securities. For corporations, investment bankers offer information on when and how to place their securities on the open market, an activity very important to an investment bank's reputation. Therefore, investment bankers play a very important role in issuing new security offerings.