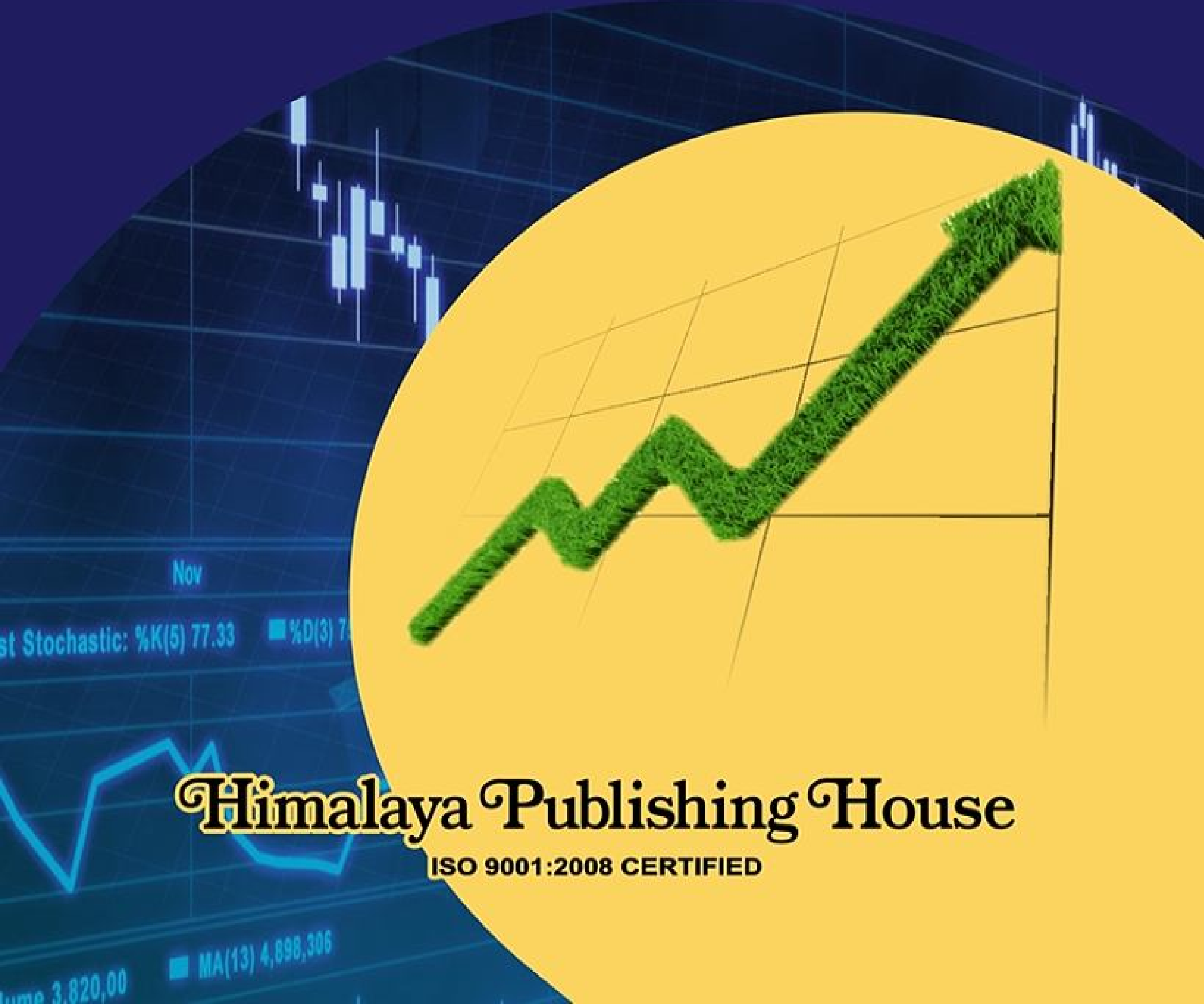
FINANCIAL SYSTEM OF INDIA, MARKETS AND SERVICES

Dr. Manisha Khaladkar-Khedekar



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PREFACE

It is indeed our pleasure and privilege to offer this book on "Financial System of India — Markets and Financial Services" to our beloved readers and students.

This book has been written in a lucid and simple manner, with a view to facilitating understanding of basic concepts and their applications from the decision maker perspective. I have provided additional material to ensure that the students are provided with a text-book, rather than just summarised notes.

I am sure that the readers, teachers and our beloved students community would find the book useful not only from an examination point of view but also for understanding of the concepts and their empirical/managerial applications.

This book gathers all the information the students need in a single book, thus making up for the paucity of relevant books on the subject. Its objective is to enable the readers to have a clear idea about the essentials of the financial sector such as financial system of India, markets and financial services.

I believe, this book will definitely generate sustained interest in the minds of the students and also by the academic community. Still constructive comments and useful suggestions for the improvement of this book are always welcome.

— AUTHOR

CONTENTS

1

Financial System

Introduction

An overview of Indian Financial System the word system 'implies a set of complex and interrelated factors organised in a particular form. These factors are mostly interdependent but not always mutually exclusive. The financial system of any country consists of several ingredients.

It includes financial institutions, markets, financial instruments, services, transactions, agents, claims and liabilities in the economy. Financial system is a system to canalize the funds from the surplus units to the deficit units. A deficit unit is a case where current expenditure exceeds their current income. There are other entities whose current income exceeds current expenditure which is called Surplus Units. An efficient financial system not only encourages savings and investments, it also efficiently allocates resources in different investment avenues and thus, accelerates the rate of economic development. The financial system of a country plays a crucial role of allocating scarce capital resources to productive uses. Its efficient functioning is of critical importance to the economy.

1.1 FINANCIAL SYSTEM

It is a system for the efficient management and creation of finance. According to Robinson, financial system provides a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth.

According to Van Horne, financial system is defined as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users — either for investment in real assets or for consumption. Thus the financial system mainly stands on three factors.

— Money

— Credit

— Finance

1. Money is the unit of exchange or medium of payment. It represents the value of financial transactions in qualitative terms.
2. Credit on the other hand, is a debt or loan which is to be returned normally with interest.
3. Finance is monetary wealth of the state, an institution or a person. Comprising these factors in a systematic order forms a financial system.

Objectives

The objectives of the financial system are:

1. Accelerating the growth of economic development.
2. Encouraging rapid industrialisation.
3. Acting as an agent to various economic factors such as Industry, Agricultural sector, Government etc.
4. Accelerating rural development.
5. Providing necessary financial support to industry.
6. Financing housing and small-scale industries.
7. Development of backward areas, infrastructure and livelihood.
8. Imposing price control in need.
9. Protecting environment.

1.2 FUNCTIONS OF FINANCIAL SYSTEM

Functions of financial system are distributed from creation of money to efficient management. It is the sum total of the functions of the various intermediaries.

The functions of financial system can be classified into two broad categories:

1. Controlling functions
2. Promotional functions.

1. Controlling Functions

Government imposes certain controls over the financial and business activities of different organisations through the regulatory bodies, *e.g.,* RBI plays an important part in regulatory functions. They are: (i) Supervision of financial institutions, (ii) Restrictions on interest and bank rates, (iii) Selective credit control, (iv) Controlling foreign exchange, (v) Regulation of stock exchanges, (vi) Framing rule for effective portfolio management and distribution, diversification and reduction of risk, (vii) Imposing monetary control, (viii) Prevention of unfair trade practices, (ix) Formulating policies on licensing, investment or credit, (x) Acting as the government's and other banks' bankers.

2. Promotional Functions

The promotional activities are:

(i) Efficient operation of the payment mechanism.

(ii) Managing information to make it easily available to all interested parties.

(iii) Providing training to investors, intermediaries and employees in order to upgrade their skills.

(iv) Conducting development and research activities in order to update the system.

(v) Creation and establishment of need-based financial institutions.

(vi) Promotion of fair practices which are transparent and effective.

(vii) Creating financial awareness to captivate investors, entrepreneurs and borrowers.

(viii) Organising seminar, dialogues, collection of data and publication.

The financial system helps production, capital accumulation, and growth by: (i) encouraging savings, (ii) mobilising them, and (iii) allocating them among alternative uses and users. Each of these functions are important and the efficiency of a given financial system depends on how well it performs each of these functions.

(i) Encourage Savings:

Financial system promotes savings by providing a wide array of financial assets as stores of value aided by the services of financial markets and intermediaries of various kinds. For wealth holders, all this offers ample choice of portfolios with attractive combinations of income, safety and yield.

With financial progress and innovations in financial technology, the scope of portfolio choice has also improved. Therefore, it is widely held that the savings-income ratio is directly related to both financial assets and financial institutions. That is, financial progress generally insures larger savings out of the same level of real income.

As stores of value, financial assets command certain advantages over tangible assets (physical capital, inventories of goods, etc.) they are convenient to hold, or easily storable, more liquid, that is more easily cashable, more easily divisible, and less risky.

A very important property of financial assets is that they do not require regular management of the kind most tangible assets do. The financial assets have made possible the separation of ultimate ownership and management of tangible assets. The separation of savings from management has encouraged savings greatly.

Savings are done by households, businesses, and government. Following the official classification adopted by the Central Statistical Organisation (CSO), Government of India, we reclassify savers into — household sector, domestic private corporate sector, and the public sector.

The household sector is defined to comprise individuals, non-government, non-corporate entities in agriculture, trade and industry, and non-profit making organisations like trusts and charitable and religious institutions.

The public sector comprises Central and State governments, departmental and non-departmental undertakings, the RBI, etc. The domestic private corporate sector comprises non-government public and private limited companies (whether financial or non-financial) and corrective institutions.

Of these three sectors, the dominant saver is the household sector, followed by the domestic private corporate sector. The contribution of the public sector to total net domestic savings is relatively small.

(ii) Mobilisation of Savings:

Financial system is a highly efficient mechanism for mobilising savings. In a fully-monetised economy this is done automatically when, in the first instance, the public holds its savings in the form of money. However, this is not the only way of instantaneous mobilisation of savings.

Other financial methods used are deductions at source of the contributions to provident fund and other savings schemes. More generally, mobilisation of savings takes place when savers move into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, bill, bonds, equity shares, etc.

(iii) Allocation of Funds:

Another important function of a financial system is to arrange smooth, efficient, and socially equitable allocation of credit. With modern financial development and new financial assets, institutions and markets have come to be organised, which are replaying an increasingly important role in the provision of credit.

In the allocative functions of financial institutions lies their main source of power. By granting easy and cheap credit to particular firms, they can shift outward the resource constraint of these firms and make them grow faster.

On the other hand, by denying adequate credit on reasonable terms to other firms, financial institutions can restrict the growth or even normal working of these other firms substantially. Thus, the power of credit can be used highly discriminately to favour some and to hinder others.

1.3 SIGNIFICANCE OF FINANCIAL SYSTEM

Financial system of a country or an organisation is the main motivating factor to run the economy. It ensures that transactions are effected smoothly and quickly on an on-going basis. It enables the financial agents to accelerate financial growth and economic prosperity of the unit.

The significance of financial system are:

(i) It involves an efficient operation of payment mechanism.

(ii) Enhancing liquidity of financial claims through securities trading.

(iii) Portfolio management.

(iv) Diversification and reduction of financial risk.

(v) Acting as intermediaries between savers and investors.

1.4 FINANCIAL SYSTEM IN INDIA

The evolution of the financial system in India is nothing but the reflections of its political and economic history. The evolution process has been influenced by the factors of urbanisation of society, advent or large-scale industrialisation, introduction of railways and telegraphic communications in the 19th century, nationalisation of financial institutions in 20th century and implementation of information technology on the eve of the 21st century. The growth of Indian Financial System is not the outcome of a normal process of development; rather, it is created by the government and mainly expanded through its intervention. Government policies have greatly influenced the interest rates, credit control and functions of financial intermediaries.

Pre independence Situations

During the 274 year regime of the East India Company (1600-1874) the financial system of the country was not at all organised. It was monopolised by the mercantile houses who were involved in banking business by providing loans, receiving deposits and issuing currency. They are commonly known as agency houses, who actually laid the foundation of modern banking. The formal banking business was developed by establishment of three Presidency Banks, namely apart from these, some exchange banks and Indian joint stock banks were set up. In 1858, as a consequence of Sepoy Mutiny, the administrative power of the East India Company was transferred to the Governor General of India.

The financial system of the country started to be organised during this period. In 1861, the Central Government took the responsibility of issuing currency notes throughout the country. Between 1865 to 1905, nine joint stock banks, each with a capital of ₹ 5 lakhs and over were established. In 1921, the three Presidency Banks were amalgamated under a special legislation to form the Imperial Bank of India. The first Central bank was established in 1935 in the country which is known as the Reserve Bank of India. At the time of independence, banking system in India was controlled by RBI, IBI, exchange banks, cooperative banks and Indian joint stock banks and the total deposits in these banks during 1948 were ₹ 957 crores.

During this period, the banking sector was in the making though there was lack of supply of long-term funds to all industrial units, especially to small-scale industries. The cooperative movement did not help much as it was disorganised and not properly aided with adequate funds. In the fields of small savings and post office savings, bank played a vital role to accumulate deposits, though it is insignificant in terms of total deposits in the country.

The private sector acted a strong role in the stock market during the first half of the 20th century. The first stock exchange was established at Bombay in 1887 where the private sector industrial units and the Government raised large amount of funds. The paid-up capital of Joint Stock companies increased from ₹ 24 crores in 1890 to ₹ 570 crores in 1948 with an average capital issue of ₹ 70 crores per year during 1918 to 1939. This boom is due to the increased; pace of industrialisation, protection of domestic industries and government policies during this period.

Post Independence Era (1950-1991)

During this period, the Indian financial system passed the second phase of evolution. It has grown rapidly since 1950 in terms of size, innovations, diversity, complicity and sophistication. The banking system has been expanded in the rural areas through the establishment of State Bank of India in 1955. In 1951, economic planning was initiated in India. The mixed economy model has been adopted which enhanced government control over the financial system and direct government participation in industrialisation process.

The different landmarks during this phase were:

- Bank nationalisation in 1969.
- Establishment of various financial institutions which are need-based and useful for expansion of financial sector.

- Imposing overall control on insurance sector by the Government.
- Establishment of large scale industrial units and introduction of long-term finance to all industries.
- Emphasizing the growth of small-scale industries by helping them through subsidised funding and direct investment.
- Imposition of regulatory measures and inserting Government intervention in business through amending the Companies Act, Securities Contracts (Regulation) Act, 1956, Monopolies and Restrictive Trade Practices Act 1970, Foreign Exchange Regulation Act 1973, etc.

Era after Liberalisation

The announcement of the New Economic Policy in 1991, the India Financial System has shown flexibility in terms of transformation. The reformation process has been started in order to remove the stagnation of growth described before and, till date, the response is positive. This is the phase of liberalisation and globalisation of Indian economy following the world trend which is duly supported by deregulation of Government control. Market force becomes dominant resulting in privatisation of industries, emergence of new generation financial institutions with competitive ability and introduction of computerised business environment where information technology plays a vital role. The regulatory framework has been duly changed giving space to this reform process and one can say that the Indian financial sector is gradually moving towards attainment of global standards.

1.5 STRUCTURE OF INDIAN FINANCIAL SYSTEM

Financial system is a system of arranging different types of funds required for the Business. It deals about —

(a) Financial Institutions

(b) Financial Markets

(c) Financial Instruments

(d) Financial Services

(A) Financial Institutions

A financial intermediary is an institution which connects the deficit and the surplus. The best example of an intermediary can be a bank which transforms the bank deposits to bank loans. The role of financial intermediary is to channel funds from people who have extra inflow of money, *i.e.*, the savers to those who do not have enough money to fulfill the needs or to carry out the basic activities, *i.e.*, the borrowers.

Functions of Financial Intermediaries

Functions of Financial Intermediary are basically classified in three parts which are as follows:

- Maturity transformation — Deals with the conversion of short-term liabilities to long-term assets.
- Risk transformation — Conversion of risky investments into relatively risk-free ones.
- Convenience denomination — Way of making the unmatched matching which is matching small deposits with large loans and large deposits with small loans.

Financial Intermediaries are classified into two types namely, Depository and Non-depository Institutions.

Structure of Financial Institutions:

Commercial Banks

Classification of Commercial Banks

— Financial Institutions

— Banking

— Non-banking Companies

— Non-banking Financial Companies

— Central Bank

— Commercial

— Banks

— Co-operative Banks

— Non-banking Financial Intermediaries

— Joint Stock Companies

Classification of Co-operative Banks

Non-banking Financial Intermediaries

Classification of Non-banking Financial Intermediaries

(B) Financial Markets

Financial system operates through financial markets and institutions.

The Indian Financial system (financial markets) is broadly divided under two heads:

(i) Indian Money Market

(ii) Indian Capital Market

The Indian money market is the market in which short-term funds are borrowed and lent. The money market does not deal in cash, or money but in bills of exchange, grade bills and treasury bills and other instruments. The capital market in India on the other hand is the market for the medium-term and long-term funds.

Components of Financial Market

— Co-operative Banks

— State Co-operative

— Apex Banks

— State Co-operative Urban Banks

— Co-operative Land Development Banks

— Central Co-operative Banks

— Primary Co-operative Banks

— Land Development Banks

— Primary Co-operative Banks

(a) Capital Market

It is the market for long-term funds, *i.e.*, raising capital for companies through issue of shares and debentures. The Capital market can further divided into: (a) Primary Market, and (b) Secondary Market.

Classification of Capital Market

(I) Primary Market: It is the market for primary needs of the company . The Company sells its shares at the time of promotion and the investors directly buy the shares from company through application.

(II) Secondary Market: It is the market for secondary needs of the company. The sale and purchase of securities, *i.e.*, shares and debentures will take place through the recognised stock exchanges.

(b) Money Market

It is a market for short-term funds. Money market provides working capital.

(c) Foreign Money Market

It is a market for foreign exchange which is bought and sold. In India the foreign market is controlled by Reserve Bank of India. Foreign Exchange Management Act (FEMA) deals with foreign exchange.

(d) Government Securities Market

Financial system enables the state and central governments to raise both short-term and long-term funds through the issue of bills and bonds which carry attractive rates of interest along with tax concessions. The budgetary gap is filled only with the help of government securities market. Thus, the capital market, money market along with foreign exchange market and government securities market enable businessmen, industrialists as well as governments to meet their credit requirements. In this way, the development of the economy is ensured by the financial system.

(C) Financial Instruments

Financial instruments include both instruments and products. Instruments include cheques, drafts, letter of credit, travellers' cheques, commercial paper, GDRs, bonds, etc. Products may be in the form of Credit Cards, Debit Cards, etc.

Classification of Financial Instruments

(a) **Negotiable Instruments:** A negotiable instrument is an instrument that is transferable from one person to another. Negotiable instrument may be a bearer instrument or an order instrument. A negotiable instrument may be promissory notes, bills of exchange or cheque, etc.

(b) **Commercial Paper:** A commercial paper is one which is issued by leading financial institution which can be taken by any borrower and discounted with commercial banks.

(c) **Bill of Lading:** It is a document signed by the carrier, acknowledging shipment of the goods and containing the terms and conditions of carriage.

(d) **Letter of Credit:** It is a letter by the importer bank guaranteeing the credit worthiness of the importer.

(e) **Travellers Cheques:** It is a cheque issued by banks to the traveling public which can be cashed with ease.

(D) Financial Services

Financial service, as a part of financial system provides different types of finance through various credit instruments, financial products and services. It enables the user to obtain any asset on credit according to his convenience and at a reasonable interest rate.

Financial services are those services which helps people in management of their finance-related problems in a well-organised manner and therefore, eliminating the worry of people regarding their money. Given below are the various types of financial services which one can expect getting from financial institutions —

1. **Banking:** Under this an individual can deposit his or her money and can get return in the form of interest and also borrowers can get loan by paying interest to bank periodically.

2. **Insurance:** By using this one can get peace of mind as one can buy insurance policies like life insurance, fire, marine, health and general insurance which ensures that person in the event of any mishap can get his or her money back from insurance company.

3. **Stock Market:** One can invest his or her funds into stock market also where one gets dividends and also capital appreciation, if one makes right investment decision then return from equity markets are much greater than that of fixed deposits parked in banks.

4. **Treasury or Debt Instruments:** Under this one can invest his or her money into government bonds and also debt instruments of private and public firms.

5. **Wealth Management:** There are many firms where one can just park their money and then these companies invest money across different assets classes like commodity, derivatives, money market, currency, etc… in order to generate superior returns for their clients.

6. **Mutual Funds:** These funds track asset class and generate returns accordingly. So a debt fund will track returns of debt and money market, an equity mutual fund would give returns according to performance of stock market and so on.

7. **Tax consultants and audit firms:** These organisations help people in determining their tax liability, advising their clients on how to save tax and also filing of their tax returns on time.

Various Financial Services

The financial services may be classified into two groups:

- Fund or Asset-based financial services
- Fee-based advisory services.

Fund or Asset-based Financial Services

The Indian financial services industry until the early seventies was rather unexciting. The financial services sector was reborn in the mid-seventies when a series of innovative services hit the financial system. The country witnessed an explosive growth of financial companies during the early eighties. The asset or fund-based financial services include the following:

- Lease financing
- Hire purchase finance and consumer credit

- Factoring and forfeiting
- Bills discounting
- Housing finance
- Insurance services
- Venture capital financing

Fee-based Advisory Services

The emerging financial services sector in India also provides fee-based advisory services to corporate enterprises. These services include the business of issue management either by making arrangement regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory services in relation to such issue management. The institutions or persons engaged in such activities are merchant bankers, stock brokers, credit rating agencies, etc.

Constituents of the Financial Services Sector

The financial services sector constitutes the following elements:

1. **Government:** The Central Government is the most important constituent of the financial services sector. It has wide powers under various Acts to regulate the sector.
2. **Regulatory Agencies:** In India, SEBI and the Reserve Bank of India act as the regulatory agencies in the sector.
3. **Financial Institutions:** Various financial institutions also play an important role in the sector.
4. **Other Constituents:** The financial services sector has the following three major elements:
   - **(a)** ***Instruments:*** These include public issue of shares, debentures, fixed deposit certificates, etc.
   - **(b)** ***Market player:*** Banks, financial institutions, mutual funds, stock exchanges, merchant bankers, portfolio managers, stockbrokers, non-banking financial institutions, financial consultants, etc., are included.
   - **(c)** ***Specialised financial institutions:*** These institutions include the Credit Rating Information Services of India Ltd. (CRISIL), the Information and Investment Credit Rating Association (IICRA), the Discount and Finance House of India Ltd. (DFHIL), the Stock Holding Corporation of India Ltd. (SHCIL) and the Over-the-counter Exchange of India (OTCEI).

Activities of the Financial Services Sector

The financial services sector is involved in two types of activities:

- Fund-based activities
- Non-fund-based activities

Fund-based Activities

These include underwriting of or investment in shares, debentures, or bonds of new issues, dealing in secondary market, participating in money market, equipment leasing, hire purchase, venture capital and seed capital. It also participates in foreign exchange activities.

Non-fund-based Activities

Apart from the provision of finance, the customers, both individuals and corporates, expect more from the financial services sector. So, it has come forward to render a large variety of services such as managing capital issues, making arrangements for the placement of capital and debt instruments, and arrangement of funds from financial institutions, etc. It also undertakes the responsibility of getting all government and other clearances.

In addition to the above activities, this sector does a large number of other services to their clients. For example, rendering project advisory services, plan mergers and acquisitions, and guiding in capital restructuring.

1.6 FINANCIAL SERVICES IN INDIA

The financial services scenario in India in the past has undergone drastic changes. In the sixties, India had a traditional pattern in the financial sector. Most companies followed a strictly regimented debt equity pattern. The primary capital market remained inactive and the secondary capital market was somewhat disorganised. Banks, financial institutions and few brokers dominated the financial services scene. With the passing of the Foreign Exchange Regulation Act of 1973, there was a spurt in public issues and the investing public was given an opportunity to invest in some of the blue chip multinational companies. This created certain amount of confidence in the primary capital market and the number of shareholders began to increase. The bank nationalisation gave the impetus to the growth of banking habits. The agricultural sector also generated some surplus. The industrial production also increased. The combined result of all these economic factors helped the growth of primary and secondary capital markets as well as the money markets at a very fast rate. An important characteristic of such growth was the expansion of financial services.

Changes in the Indian Economy

(i) Significant diversification and policy reformation has led to the restructuring of the financial institutions, which in turn have accompanied the growth of Indian Financial System largely.

(ii) In the past 50 years the Indian financial system has shown tremendous growth in terms of quantity, sophistication, innovations and complexity of operation, diversity, involvement.

(iii) Major financial indicators which include money supply, deposits and credit of banks, primary and secondary issues have increased rapidly.

(iv) India has also witnessed all the major types of financial innovations like diversification, disintermediation, securitisation, liberalisation, globalisation, privatisation, etc.

(v) The financial institutions and a large number of new financial instruments lead a fairly diversified portfolio of financial claims which altogether have helped India to position itself in Global market.

1.7 ROLE OF FINANCIAL SYSTEM IN ECONOMIC DEVELOPMENT

One of the important sustainability requisite for the accelerated development of an economy is the existence of a dynamic financial market. A financial market helps the economy in the following manner.

1. **Saving mobilization:** Obtaining funds from the savers or surplus units such as household individuals, business firms, public sector units, central government, state governments etc. is an important role played by financial markets.

2. **Investment:** Financial markets play a crucial role in arranging to invest funds thus collected in those units which are in need of the same.

3. **National Growth:** An important role played by financial market is that, they contribute to a nation's growth by ensuring unfettered flow of surplus funds to deficit units. Flow of funds for productive purposes is also made possible.

4. **Entrepreneurship Growth:** Financial market contributes to the development of the entrepreneurial claw by making available the necessary financial resources.

5. **Industrial Development:** The different components of financial markets help an accelerated growth of industrial and economic development of a country, thus contributing to raising the standard of living and the society of well-being.

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