Indian Financial System

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Introduction

- A financial system plays a vital role in the economic growth of a country. It intermediates between the flow of funds belonging to those who save a part of their income and those who invest in productive assets. It mobilises and usefully allocates scarce resources of a country.
- A financial system is a complex, well-integrated set of sub-systems of financial institutions, markets, instruments, and services which facilitates the transfer and allocation of funds, efficiently and effectively.

The Indian Financial System

- The Indian financial system can also be broadly classified into the formal (organised) financial system and the informal (unorganised) financial system.
- The formal financial system comes under the purview of the Ministry of Finance (MoF), the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), and other regulatory bodies.
- The informal financial system consists of:
- Individual moneylenders such as neighbours, relatives, landlords, traders, and storeowners.
- Groups of persons operating as ‘funds’ or ‘associations.’ These groups function under a system of their own rules and use names such as ‘fixed fund,’ ‘association,’ and ‘saving club.’
- Partnership firms consisting of local brokers, pawnbrokers, and non-bank financial intermediaries such as finance, investment, and chit-fund companies.

Formal and Informal Financial Sectors

- The formal financial sector is characterised by the presence of an organised, institutional, and regulated system which caters to the financial needs of the modern spheres of economy;
- the informal financial sector is an unorganised, non-institutional, and non-regulated system dealing with the traditional and rural spheres of the economy.
- The informal financial sector has emerged as a result of the intrinsic dualism of economic and social structures in developing countries, and financial repression which inhibits the certain deprived sections of society from accessing funds. The informal system is characterised by flexibility of operations and interface relationships between the creditor and the debtor.

COMPONENTS OF THE FORMAL FINANCIAL SYSTEM

- The formal financial system consists of four segments or components. These are: financial institutions, financial markets, financial instruments, and financial services
- **Classification of Financial Institutions**
- Banking and non-banking
- Term finance
- Specialised
- Sectoral
- Investment
- State-level

Financial Institutions

- These are intermediaries that mobilise savings and facilitate the allocation of funds in an efficient manner.
- Financial institutions can be classified as banking and non-banking financial institutions.
- Banking institutions are creators and purveyors of credit while non-banking financial institutions are purveyors of credit.
- While the liabilities of banks are part of the money supply, this may not be true of non-banking financial institutions.
- In India, non-banking financial institutions, namely, the developmental financial institutions (DFIs), and non-banking financial companies (NBFCs) as well as housing finance companies (HFCs) are the major institutional purveyors of credit.

FUNCTIONS OF A FINANCIAL SYSTEM

1. One of the important functions of a financial system is to link the savers and investors and, thereby, help in mobilising and allocating the savings efficiently and effectively. By acting as an efficient conduit for allocation of resources, it permits continuous upgradation of technologies for promoting growth on a sustained basis.
2. A financial system not only helps in selecting projects to be funded but also inspires the operators to monitor the performance of the investment. Financial markets and institutions help to monitor corporate performance and exert corporate control through the threat of hostile takeovers for underperforming firms.
3. It provides a payment mechanism for the exchange of goods and services and transfers economic resources through time and across geographic regions and industries. Payment and settlement systems play an important role to ensure that funds move safely, quickly, and in a timely manner. An efficient payment and settlement system contributes to the operating and allocation efficiencies of the financial system and thus, overall economic growth. Payment and settlement systems serve an important role in the economy as the main arteries of the financial sector.

FUNCTIONS OF A FINANCIAL SYSTEM

4. One of the most important functions of a financial system is to achieve optimum allocation of risk bearing. It limits, pools, and trades the risks involved in mobilising savings and allocating credit. An efficient financial system aims at containing risk within acceptable limits. It reduces risk by laying down rules governing the operation of the system. Risk reduction is achieved by holding diversified portfolios and screening of borrowers. Market participants gain protection from unexpected losses by buying financial insurance services.

5. A financial system also makes available price-related information which is a valuable assistance to those who need to take economic and financial decisions. Financial markets disseminate information for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment, or holding a particular asset. This information dissemination enables a quick valuation of financial assets.

6. A financial system also offers portfolio adjustment facilities. These are provided by financial markets and financial intermediaries such as banks and mutual funds. Portfolio adjustment facilities include services of providing a quick, cheap and reliable way of buying and selling a wide variety of financial assets.

7. A financial system helps in the creation of a financial structure that lowers the cost of transactions. This has a beneficial influence on the rate of return to savers. It also reduces the cost of borrowing. Thus, the system generates an impulse among the people to save more.

8. A well-functioning financial system helps in promoting the process of financial deepening and broadening. Financial deepening refers to an increase of financial assets as a percentage of the Gross Domestic Product (GDP).

KEY ELEMENTS OF A WELL-FUNCTIONING FINANCIAL SYSTEM

- The basic elements of a well-functioning financial system are:
- (i) a strong legal and regulatory environment,
- (ii) stable money,
- (iii) sound public finances and public debt management,
- (iv) a central bank,
- (v) a sound banking system,
- (vi) an information system, and
- (vii) a well-functioning securities market.

Case Study

- In the 1950s and 1960s, Gurley and Shaw (1955, 1960, 1967) and Goldsmith (1969) discussed the stages in the evolution of financial systems. According to them, there is a link between per capita income and the development of a financial system. At low levels of development, most investment is self-financed and financial intermediaries do not exist, as the costs of financial intermediation are high relative to benefits.
- As countries develop and per capita income increases, bilateral borrowing and lending take place leading to the birth of financial intermediaries. The number of financial intermediaries grows with further increases in per capita income. Among the financial intermediaries, banks tend to become larger and prominent in financial investment. As countries expand economically, non-bank financial intermediaries and stock markets grow in size and tend to become more active and efficient relative to banks. There is a general tendency for financial systems to become more market-oriented as countries become richer.

Shares

- Shares are often referred to as equities. They represent ownership of the company, just as you have equity in your house: the percentage of your house that you own when the building society's loan is deducted.
- The names of the shareholders and the number of shares held will be kept on a share register. Each time a batch of shares changes hands, the new shareholder will be recorded on the register.
- Each share has a nominal value. This was the value of each share when the company was originally formed.

Shares

- Shares are issued by the company when it is set up. Investors put money in to get the company going.
- Premises have to be bought or rented, machinery may be needed, staff have to be paid, materials bought … all this before any money comes in from customers. In return, the investors are allocated a stake in the company.
- Money, or capital as it is referred to, is one of the many inputs that a company needs. Capital can come through the founders putting their hands in their pockets, from taking out bank loans or from selling shares.

Preference shares

- There is one other class of shares apart from ordinary shares and they are called preference shares.
- These are in fact more like loans than shares. Preference shareholders do not have voting rights except on issues that specifically affect them.
- They receive a set rate of interest, usually twice a year, just as you would receive a rate of interest on a savings account in a bank or building society.
- Dividends on preference shares must be paid before dividends on ordinary shares and if the company goes bust any cash left over when the creditors have been paid off goes to the preference shareholders first.
- That’s why they are called preference shares.

Bonds

- Bonds are contracts issued by companies and government bodies to raise there funds for medium to long term. Which means a company or government organizations can fulfill there medium/long term financial needs by taking loan from the general public by issuing debt instrument, called bonds.
- Bonds are supposed to be a secured investment but offers low to medium interest rate. It is called as secured investment because if the company goes bankrupt those who hold bonds are the first once to receive there money.
- Having a bond does not make you a shareholder and you do not have the right to vote in the general meetings of the company.

Debentures

- Debentures are debt instruments issued by companies to raise there funds for short or medium term. Which means a company can fulfill there short/medium term financial needs by taking loan from the general public by issuing debt instrument, called as debentures. Investors get a fixed rate of interest known as coupon rate in the form of return on there investment in debentures periodically.
- Debentures are freely transferable but having a debentures does not make you a shareholder and you do not have the right to vote in the general meetings of the company.

Types of Debentures

- **Secured Debentures :-** Secured debentures are secured against the security of a fixed asset of the company. Which means if the company will not be able to repay the amount of loan taken from the investor, his asset can be sold to repay the liability of the investor.
- **Unsecured Debentures :-** As name suggest these type of debentures are not secured against any company asset. Which means there is no obligation on the company to repay the amount back to the investor when debenture comes due.
- **Convertible Debentures :-** As name suggest these type of debentures can be converted either into equity shares or any other security at a later date. These debentures are either fully convertible or partly convertible depending upon the terms and conditions of the debentures.
- **Non Convertible Debentures :-** The debentures which cannot be converted into any other securities or shares are called as non convertible debentures. This type of debentures offers higher rate of interest in comparison to convertible debenture.
- the other type of debentures includes registered debenture, Bearer debentures, redeemable debentures and irredeemable debentures.

Difference Between Debentures And Bonds

- Bonds are secured in comparison to debentures
- Bonds are usually issued by the government bodies while debentures are issued by private companies.
- Bond offers lower interest rate in comparison to debentures
- Bondholders do not receive periodic payments and receive the principal plus interest at the end of the term whereas debenture holders receive periodic interest payments.
- Bond is a long term debt instrument that promises to pay a fixed annual interest over a specific period whereas debenture is a medium term debt instrument.
- Debentures can be convertible into equity shares while bonds are not.

Certificate of Deposit (CD)

- A certificate of deposit (CD) is a savings certificate with a fixed maturity date and specified fixed interest rate that can be issued in any denomination aside from minimum investment requirements.
- A CD restricts access to the funds until the maturity date of the investment.
- CDs are generally issued by commercial banks and are insured by the Federal Deposit Insurance Corporation (FDIC) up to $250,000 per individual.

Certificate of deposit

- A certificate of deposit (CD) is a promissory note issued by a bank. It is a time deposit that restricts holders from withdrawing funds on demand.
- A CD is typically issued electronically and may automatically renew upon the maturity of the original CD.
- When the CD matures, the entire amount of principal, as well as interest earned, is available for withdrawal.
- CDs typically do not have a fee unless withdrawn before the maturity date. Most CDs offer higher interest rates than those available from savings and money market accounts.

Treasury bill

- Treasury bills, or T-bills, are short-term debt instruments issued by the government.
- T-bills are issued for a term of one year of less.
- T-bills are considered the world's safest debt as they are backed by the full faith and credit of the government.
- The T-bill rate is a key barometer of short-term interest rates. Treasury bills are sold with maturities of four, thirteen, twenty-six and fifty-two weeks.
- They do not pay interest, but rather are sold a discount to their face value.
- The full-face value is paid at maturity, and the difference between the discounted purchase price and the full-face value equates to the interest rate.

Treasury bill

- There are three ways to purchase T-bills and all other Treasury securities:

1. *Non-competitive bid* auctions allow investors to submit a bid to purchase a set dollar amount of the Bills at the next auction. The yield they receive is based upon the average auction price from all bidders. The maximum amount that can be purchased through a non-competitive bid is $5 million.
2. *Competitive bidding* auctions are geared for those who only want to buy the bills at a specific or desired yield. These bids must be made via a bank or a broker. A buyer can purchase up to 35% of the amount of the initial offering for the bill being auctioned.
3. You can purchase them on the *secondary market or via mutual funds and ETFs*. T-bills, like all Treasury securities, can be bought and sold on the secondary market. Additionally, there are a number of mutual funds and ETFs that purchase T-bills.

Capital Market

- A **capital market** is a financial market in which long-term debt (over a year) or equity-backed securities are bought and sold.
- Capital markets channel the wealth of savers to those who can put it to long-term productive use, such as companies or governments making long-term investments. Financial regulators like the Bank of England (BoE) and the U.S. Securities and Exchange Commission (SEC) oversee capital markets to protect investors against fraud, among other duties.
- Modern capital markets are almost invariably hosted on computer-based electronic trading systems; most can be accessed only by entities within the financial sector or the treasury departments of governments and corporations, but some can be accessed directly by the public.
- There are many thousands of such systems, most serving only small parts of the overall capital markets. Entities hosting the systems include stock exchanges, investment banks, and government departments.
- Physically, the systems are hosted all over the world, though they tend to be concentrated in financial centres like London, New York, and Hong Kong.

Money Market

- The money market is where financial instruments with high liquidity and very short maturities are traded.
- It is used by participants as a means for borrowing and lending in the short term, with maturities that usually range from overnight to just under a year.
- Among the most common money market instruments are eurodollar deposits, negotiable certificates of deposit (CDs), banker's acceptances, U.S. Treasury bills, commercial paper, municipal notes, federal funds and repurchase agreements (repos).
- Money market transactions are wholesale, meaning that they are for large denominations and take place between financial institutions and companies rather than individuals.
- Money market funds offer individuals the opportunity to invest smaller amounts in these assets.

Foreign Currency Market

- The **foreign exchange market** (**Forex**, **FX**, or **currency market**) is a global decentralized or over-the-counter (OTC)market for the trading of currencies.
- This market determines the foreign exchange rate. It includes all aspects of buying, selling and exchanging currencies at current or determined prices.
- In terms of trading volume, it is by far the largest market in the world, followed by the Credit market.
- The main participants in this market are the larger international banks.
- Financial centers around the world function as anchors of trading between a wide range of multiple types of buyers and sellers around the clock, with the exception of weekends.
- Since currencies are always traded in pairs, the foreign exchange market does not set a currency's absolute value but rather determines its relative value by setting the market price of one currency if paid for with another. Ex: US$1 is worth X CAD, or CHF, or JPY, etc.

Commercial Bank

- A **commercial bank** is a type of bank that provides services such as accepting deposits, making business loans, and offering basic investment products that is operated as a business for profit.
- It can also refer to a bank, or a division of a large bank, which deals with corporations or large/middle-sized business to differentiate it from a retail bank and an investment bank.
- A commercial bank is where most people do their banking, as opposed to an investment bank.
- Commercial banks accept various types of deposits from public especially from its clients, including saving account deposits, recurring account deposits, and fixed deposits. These deposits are returned whenever the customer demands it or after a certain time period.
- Commercial banks provide loans and advances of various forms, including an overdraft facility, cash credit, bill discounting, money at call etc. They also give demand and term loans to all types of clients against proper security.

Merchant Bank

- A merchant bank is a company that deals mostly in international finance, business loans for companies and underwriting.
- These banks are experts in international trade, which makes them specialists in dealing with multinational corporations.
- A merchant bank may perform some of the same services as an investment bank, but it does not provide regular banking services to the general public.

Stock Exchanges

- A **stock exchange**, **securities exchange** or bourse, is a facility where stock brokers and traders can buy and sell securities, such as shares of stock and bonds and other financial instruments. Stock exchanges may also provide for facilities the issue and redemption of such securities and instruments and capital events including the payment of income and dividends.
- Securities traded on a stock exchange include stock issued by listed companies, unit trusts, derivatives, pooled investment products and bonds. Stock exchanges often function as "continuous auction" markets with buyers and sellers consummating transactions at a central location such as the floor of the exchange.[Many stock exchanges today use electronic trading, in place of the traditional floor trading.
- To be able to trade a security on a certain stock exchange, the security must be listed there. Usually, there is a central location at least for record keeping, but trade is increasingly less linked to a physical place, as modern markets use electronic networks, which give them advantages of increased speed and reduced cost of transactions.
- Trade on an exchange is restricted to brokers who are members of the exchange.
- In recent years, various other trading venues, such as electronic communication networks, alternative trading systems and "dark pools" have taken much of the trading activity away from traditional stock exchanges.