MODULE 1
OVERVIEW OF INDIAN FINANCIAL SYSTEM

BY.DR.SAYLEE GHARGE

Finance

What do you mean by Finance?

Finance is defined as the management of money and includes activities like investing, borrowing, lending, budgeting, saving, and forecasting.

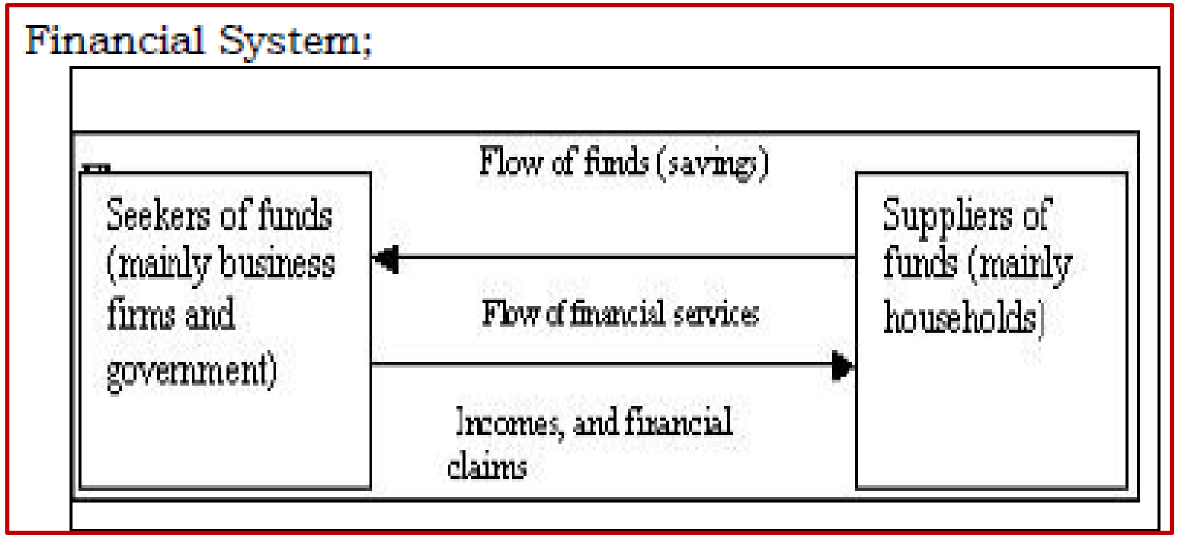
There are three main types of finance: (1) personal, (2) corporate, and
(3) public/government

According to Experts:

"Finance is a simple task of providing the necessary funds (money) required by the business of entities like companies, firms, individuals and others on the terms that are most favourable to achieve their economic objectives."

Financial System

- The economic development of a nation is reflected by the progress of the various economic units, broadly classified into corporate sector, government and household sector.
- There are areas or people with surplus funds and there are those with a deficit. A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit.
- Financial system comprises of set of subsystems of:
- ✓ Financial institutions,
- ✓ Financial markets,
- ✓ Financial instruments and services



Role and Importance of Financial System in Economic Development

1. It links the savers and investors. It helps in mobilizing and allocating the savings efficiently and effectively. It plays a crucial role in economic development through saving-investment process. This savings – investment process is called capital formation.

2. It helps to monitor corporate performance.

3. It provides a mechanism for managing uncertainty and controlling risk.

4. It provides a mechanism for the transfer of resources across geographical boundaries.

5. It offers portfolio adjustment facilities 6. It helps in lowering the transaction costs and increase returns. This will motivate people to save more.

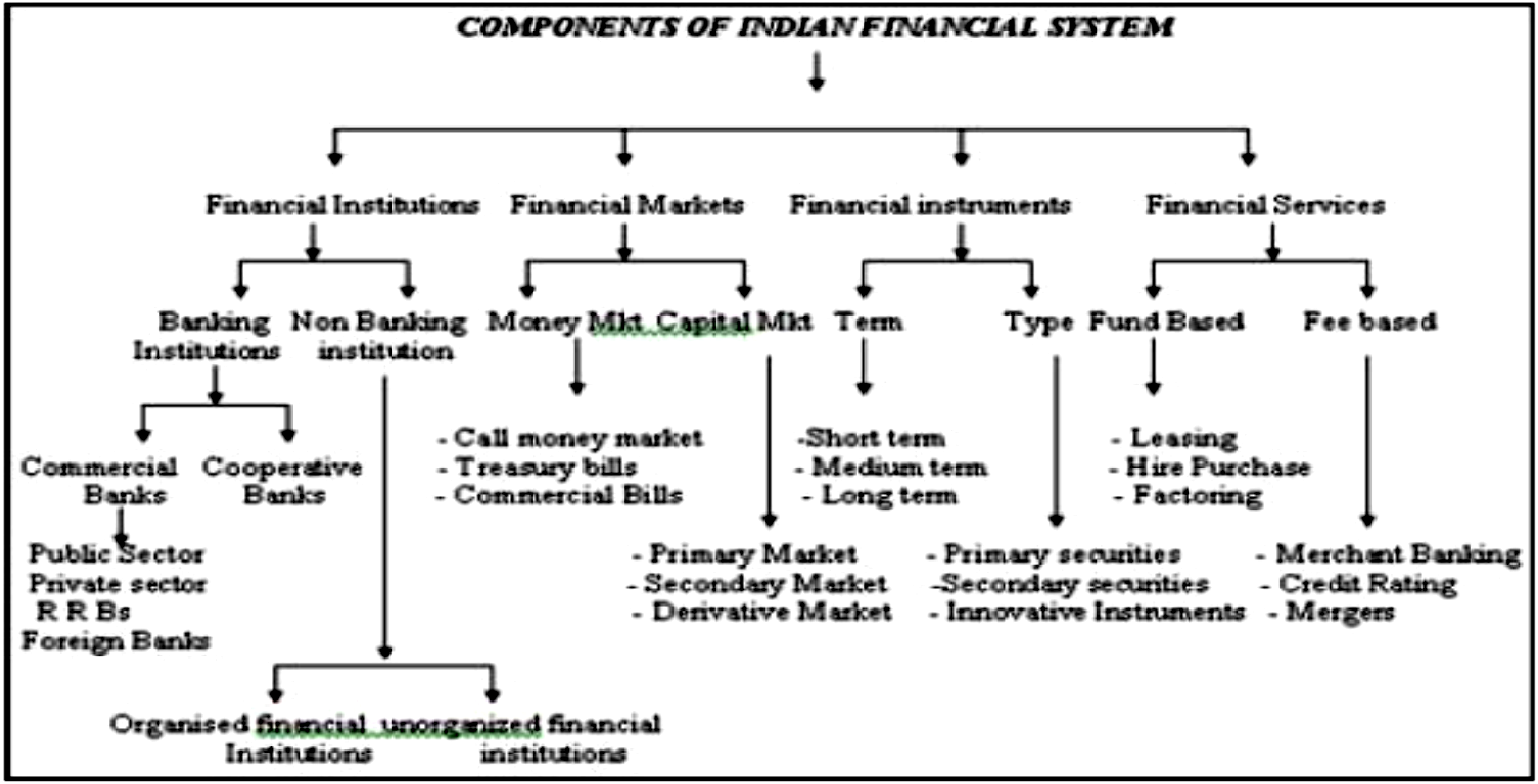
7. It promotes the process of capital formation.

8. It helps in promoting the process of financial deepening and broadening.

Functions of Financial System

- Saving function: Savings are transformed into investments
- Liquidity function: Converted into cash or money easily without loss of value.
- Payment function: Convenient mode of payment for goods and services
- Risk function : Protection against life, health and income risks.
- Information function :Disseminate information for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment or holding a particular asset.
- Transfer function: Transfer of the resources across geographic boundaries.
- Reformatory functions: Developing, introducing innovative financial assets / instruments services and practices and restructuring the existing assets, services etc.
- Other functions: selection of projects to be financed and performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

Structure of Indian Financial System



Financial Institutions

- Financial institutions are the business organizations that act as mobilizes of savings and as purveyors of credit or finance. This means financial institutions mobilize the savings of savers and give credit or finance to the investors. They also provide various financial services to the community.

- They deal in financial assets such as deposits, loans, securities and so on Financial institutions are the participants in a financial market.

- They collect resources by accepting deposits from individuals and institutions and lend them to trade, industry and others.

Financial Institutions

- They buy and sell financial instruments. They generate financial instruments as well. They deal in financial assets.

- They accept deposits, grant loans and invest in securities.

- On the basis of the nature of activities, financial institutions may be classified as: (a) Regulatory and promotional institutions,

  (b) Banking institutions, and

  (c) Non-banking institutions.

Regulatory and Promotional Institutions

- Financial institutions, financial markets, financial instruments and financial services are all regulated by regulators like Ministry of Finance, the Company Law Board, RBI, SEBI, IRDA, Dept. of Economic Affairs, Department of Company Affairs etc.
- The two major Regulatory and Promotional Institutions in India are Reserve Bank of India (RBI) and Securities Exchange Board of India (SEBI).
- Both RBI and SEBI administer, legislate, supervise, monitor, control and discipline the entire financial system.
- RBI is the apex of all financial institutions in India. All financial institutions are under the control of RBI. The financial markets are under the control of SEBI.
- Both RBI and SEBI have laid down several policies, procedures and guidelines. These policies, procedures and guidelines are changed from time to time so as to set the financial system in the right direction.

Banking Institutions

- ➢ Banking institutions mobilize the savings of the people. They provide a mechanism for the smooth exchange of goods and services. They extend credit while lending money. They not only supply credit but also create credit.
- ➢ There are three basic categories of banking institutions.
- ✓ Commercial banks,
- ✓ Co-operative banks and
- ✓ Developmental banks

Non-banking Institutions

- The non-banking financial institutions also mobilize financial resources directly or indirectly from the people. They lend the financial resources mobilized. They lend funds but do not create credit.
- Companies like LIC, GIC, UTI, Development Financial Institutions, Organization of Pension and Provident Funds etc. fall in this category.
- Non-banking financial institutions can be categorized as investment companies, housing companies, leasing companies, hire purchase companies, specialized financial institutions (EXIM Bank etc.) investment institutions, state level institutions etc.
- Financial institutions are financial intermediaries. They intermediate between savers and investors. They lend money. They also mobilize savings.

FINANCIAL MARKET

- Efficient financial markets are essential for speedy economic development. The vibrant financial market enhances the efficiency of capital formation. It facilitates the flow of savings into investment. Financial markets bridge one set of financial intermediaries with another set of players.
- Financial markets are the backbone of the economy. This is because they provide monetary support for the growth of the economy. The growth of the financial markets is the barometer of the growth of a country’s economy.
- Financial market deals in financial securities (or financial instruments) and financial services.

FINANCIAL MARKET

- Financial markets are the centers or arrangements that provide facilities for buying and selling of financial claims and services.
- Financial markets exist wherever financial transactions take place. Financial transactions include issue of equity stock by a company, purchase of bonds in the secondary market, deposit of money in a bank account, transfer of funds from a current account to a savings account etc.
- The participants in the financial markets are corporations, financial institutions, individuals and the government. These participants trade in financial products in these markets. They trade either directly or through brokers and dealers.

FINANCIAL MARKET

Financial markets refer to the institutional arrangements for dealing in financial assets and credit instruments of different types such as currency, cheques, bank deposits, bills, bonds etc.

Functions of financial markets are:

(i) To facilitate creation and allocation of credit and liquidity

(ii) To serve as intermediaries for mobilization of savings.

(iii) To assist the process of balanced economic growth.

(iv) To provide financial convenience.

(v) To cater to the various credit needs of the business houses.

FINANCIAL MARKET

Classification On The Basis Of Financial Claim

- **Debt market**
  (Fixed claims)
- **Equity market**
  (Residual claims)

1. Classification on the basis of the type of financial claim

- On this basis, financial markets may be classified into debt market and equity market.
- Debt market: This is the financial market for fixed claims like debt instruments.
- Equity market: This is the financial market for residual claims, i.e., equity instruments.

FINANCIAL MARKET

Classification On the basis of maturity of claims

Money market

short term funds are borrowed and lend.

e.g.: Treasury bill market, call money market, commercial bill market

Capital market

Long term claims, securities and stocks with a maturity period of more than one year

e.g. : The stock market, the government bond market and derivatives market

2. Classification on the basis of maturity of claims

- On this basis, financial markets may be classified into money market and capital market.
- Money market: A market where short term funds are borrowed and lend is called money market. It deals in short term monetary assets with a maturity period of one year or less. Liquid funds as well as highly liquid securities are traded in the money market.
- Examples of money market are Treasury bill market, call money market, commercial bill market etc. The main participants in this market are banks, financial institutions and government.
- In short, money market is a place where the demand for and supply of short term funds are met.

2. Classification on the basis of maturity of claims

- Capital market: Capital market is the market for long term funds. This market deals in the long term claims, securities and stocks with a maturity period of more than one year.
- It is the market from where productive capital is raised and made available for industrial purposes.
- The stock market, the government bond market and derivatives market are examples of capital market.
- In short, the capital market deals with long term debt and stock.

FINANCIAL MARKET

Classification On the basis of seasoning of claim

Primary market (new issue markets)

Deal in the new Securities , raising fresh capital in the form of shares and debentures.

Secondary market

Deal in existing securities

e.g. stock exchange

3. Classification on the basis of seasoning of claim

- On this basis, financial markets are classified into primary market and secondary market.
- Primary market: Primary markets are those markets which deal in the new securities. Therefore, they are also known as new issue markets. These are markets where securities are issued for the first time.
- In other words, these are the markets for the securities issued directly by the companies. The primary markets mobilize savings and supply fresh or additional capital to business units.
- In short, primary market is a market for raising fresh capital in the form of shares and debentures.

3. Classification on the basis of seasoning of claim

- Secondary market: Secondary markets are those markets which deal in existing securities. Existing securities are those securities that have already been issued and are already outstanding.
- Secondary market consists of stock exchanges. Stock exchanges are self regulatory bodies under the overall regulatory purview of the Govt. /SEBI

FINANCIAL MARKET

Classification on the basis of structure or arrangements

Organised markets

Transactions take place in the systematic and orderly structure.

Unorganised markets

Transactions take place

Without systematic and orderly structure

4. Classification on the basis of structure or arrangements

- On this basis, financial markets can be classified into organized markets and unorganized markets.
- Organised markets: These are financial markets in which financial transactions take place within the well established exchanges or in the systematic and orderly structure.
- Unorganized markets: These are financial markets in which financial transactions take place outside the well established exchange or without systematic and orderly structure or arrangements

FINANCIAL MARKET

Classification on the basis of timing of delivery

Cash / Spot market

Buying and selling of commodities happens or stocks are sold for cash and delivered immediately after the purchase

Forward/Future market

Delivery of commodities or securities occurs at a pre-determined time in future.

5. Classification on the basis of timing of delivery

- On this basis, financial markets may be classified into cash/spot market and forward / future market.
- Cash / Spot market: This is the market where the buying and selling of commodities happens or stocks are sold for cash and delivered immediately after the purchase or sale of commodities or securities.
- Forward/Future market: This is the market where participants buy and sell stocks/commodities, contracts and the delivery of commodities or securities occurs at a pre-determined time in future.

FINANCIAL MARKET

Other types of financial market

Foreign exchange market

one country's currency is traded for another country's currency

Derivatives market

The individuals and firms who wish to avoid or reduce risk can deal with the others who are willing to accept the risk for a price.

e.g. forwards, futures, options, swaps

6. Other types of financial market

- Apart from the above, there are some other types of financial markets. They are foreign exchange market and derivatives market.
- Foreign exchange market: Foreign exchange market is simply defined as a market in which one country's currency is traded for another country's currency. It is a market for the purchase and sale of foreign currencies.
- Derivatives market: The derivatives are most modern financial instruments in hedging risk. The individuals and firms who wish to avoid or reduce risk can deal with the others who are willing to accept the risk for a price. A common place where such transactions take place is called the derivative market. It is a market in which derivatives are traded.
- In short, it is a market for derivatives. The important types of derivatives are forwards, futures, options, swaps, etc

Financial Instruments (Securities)

- Financial instruments are the financial assets, securities and claims.
- Financial assets represent claims for the payment of a sum of money sometime in the future (repayment of principal) and/or a periodic payment in the form of interest or dividend.
- Financial liabilities are the counterparts of financial assets. They represent promise to pay some portion of prospective income and wealth to others. Financial assets and liabilities arise from the basic process of financing.
- Financial instruments are tradable/ transferable OR non tradable/non-transferable. Financial assets like deposits with banks, companies and post offices, insurance policies, NSCs, provident funds and pension funds are not tradable.

Financial Instruments (Securities)

- Securities (included in financial assets) like equity shares and debentures, or government securities and bonds are tradable. Hence they are transferable.
- **Financial instruments are instruments through which a company raises finance**.
- The financial instruments may be capital market instruments or money market instruments or hybrid instruments.
- The financial instruments that are used for raising capital through the capital market are known as capital market instruments.
- These include equity shares, preference shares, warrants, debentures and bonds. These securities have a maturity period of more than one year.

Financial Instruments (Securities)

- The financial instruments that are used for raising and supplying money in a short period not exceeding one year through money market are called money market instruments.
- Examples are treasury bills, commercial paper, call money, short notice money, certificates of deposits, commercial bills, money market mutual funds.

- Hybrid instruments are those instruments which have both the features of equity and debenture. Examples are convertible debentures, warrants etc.

Financial Instruments (Securities)

Financial instruments may also be classified as,

- ✓ Cash instruments: Cash instruments are financial instruments whose value is determined directly by markets
- ✓ Derivative instruments: Derivative instruments are financial instruments which derive their value from some other financial instrument or variable.
- ✓ Financial instruments can also be classified as:
- ✓ Primary instruments: Directly issued by the ultimate investors to the ultimate savers .e.g. shares and debentures
- ✓ Secondary instruments: Issued by the financial intermediaries to the ultimate savers. For example, UTI and mutual funds issue securities in the form of units to the public.

Characteristics of Financial Instruments

1. **Liquidity**: Financial instruments provide liquidity. These can be easily and quickly converted into cash.

2. **Marketing:** Financial instruments facilitate easy trading on the market. They have a ready market.

3. **Collateral value**: Financial instruments can be pledged for getting loans.

4. **Transferability**: Financial instruments can be easily transferred from person to person.

5. **Maturity period**: The maturity period of financial instruments may be short term, medium term or long term.

6. **Transaction cost**: Financial instruments involve buying and selling cost. The buying and selling costs are called transaction costs. These are lower.

7. **Risk**: Financial instruments carry risk. This is because there is uncertainty with regard to payment of principal or interest or dividend as the case may be.

8. **Future trading**: Financial instruments facilitate future trading so as to cover risks due to price fluctuations, interest rate fluctuations etc.

FINANCIAL SERVICES

- Efficiency of emerging financial system largely depends upon the quality and variety of financial services provided by financial intermediaries.
- The term financial services can be defined as "activities, benefits, and satisfactions, connected with the sale of money, that offer to users and customers, financial related value.
- within the financial services industry the main sectors are banks, financial institutions, and non-banking financial companies.
- Financial services provided by various financial institutions, commercial banks and merchant bankers can be broadly classified into two categories.

1. Asset based/fund based services. 2. Fee based/advisory services

Asset based/fund based service

1. **Equipment Leasing/ Lease Financing Leasing:**

- It is a arrangement that provides a firm with the use and control over assets without buying and owning the same.
- It is a form of renting assets. However, in making an investment, the firm need not own the asset.
- It is basically interested in acquiring the use of the asset. Thus, the firm may consider leasing of the asset rather than buying it

Asset based/fund based service

2. **Hire Purchase and Consumer Credit Hire purchase:**

It means a transaction where goods are purchased and sold on the terms that

(i) Payment will be made it installments,

(ii) The possession of the goods is given to the buyer immediately,

(iii) The property ownership in the goods remains with the vendor till the last installment is paid,

(iv) The seller can repossess the goods in case of default in payment of any instalment,

(v) each instalment is treated as hire charges till the last instalment is paid.

Asset based/fund based service

3.VENTURE CAPITAL:

In the real sense, venture capital financing is one of the most recent entrants in the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked. These venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters contribution as required by the financial institutions. In addition to providing capital, these VCFS (venture capital firms) take an active interest in guiding the assisted firms.

Asset based/fund based service

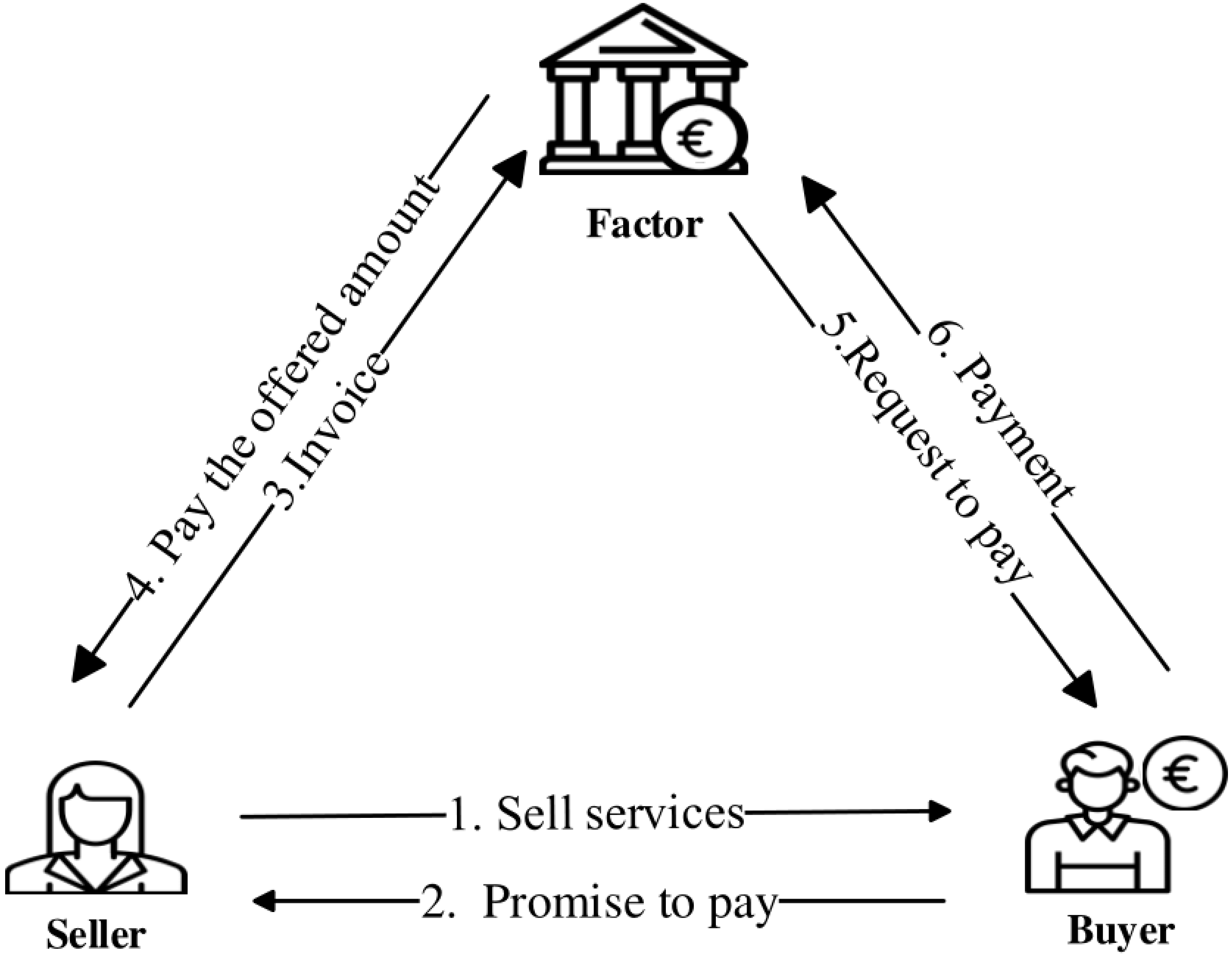
4. **Insurance Services:**

Insurance is a contract where by the insurer e. insurance company agrees/ undertakes, in consideration of a sum of money (premium) to make good the loss suffered by the insured (policy holder) against a specified risk such as fire or compensate the beneficiaries (insured) on the happening of a specified event such as accident or death. The document containing the terms of contract, in black and white, between the insurer and the insured is called policy. The property which is insured is the subject matter of insurance. The interest which the insured has in the subject matter of insurance is known as insurable interest. Depending upon the subject matter, insurance services are divided into (i) life (ii) general.

Asset based/fund based service

5. Factoring:

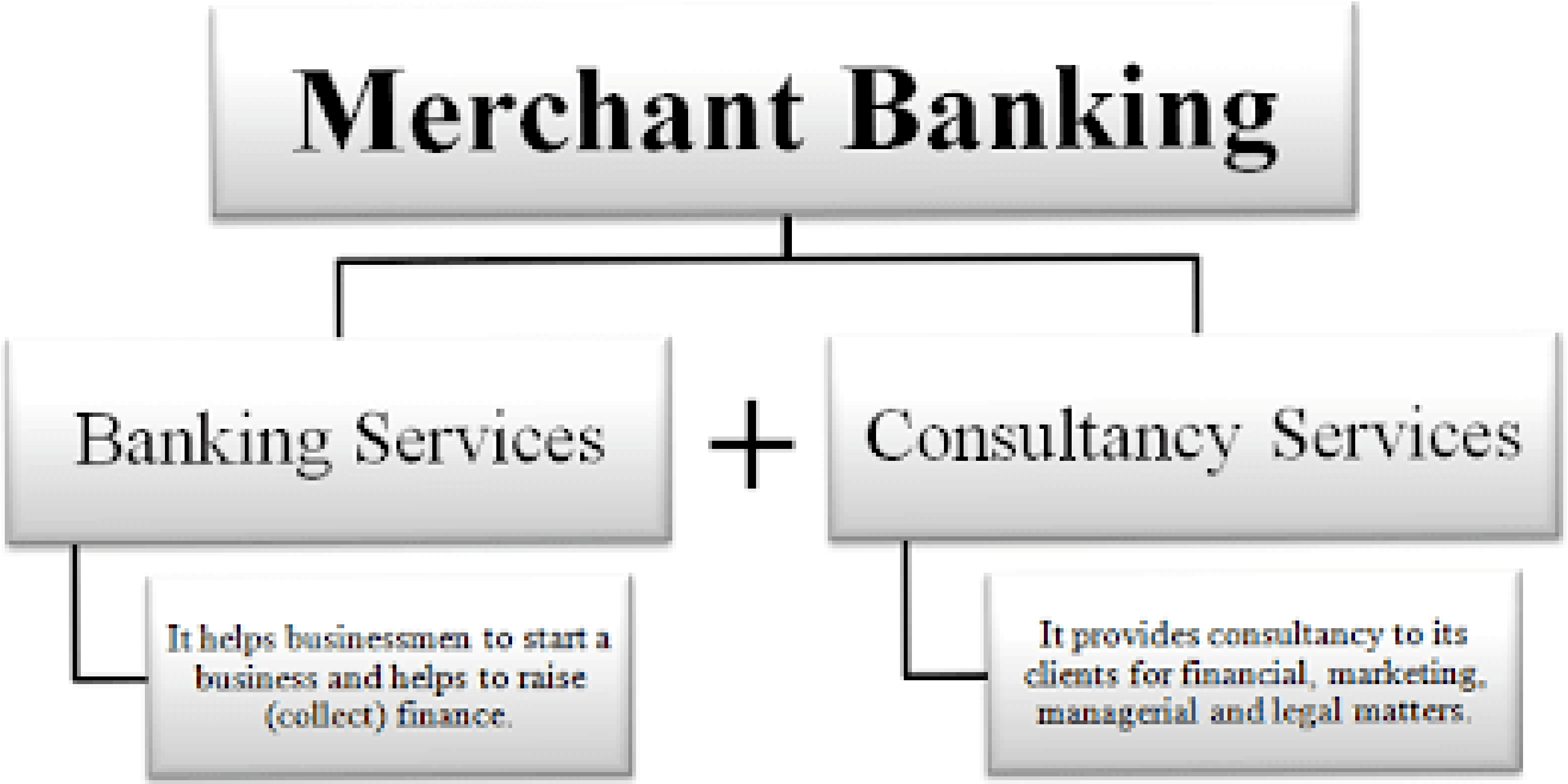
Factoring, as a fund based financial service provides resources to finance receivables as well as it facilitates the collection of receivables. It is another method of raising short - term finance through account receivable credit offered by commercial banks and factors. A commercial bank may provide finance by discounting the bills or invoices of its customers. Thus, a firm gets immediate payment for sales made on credit. A factor is a financial institution which offers services relating to management and financing of debts arising out of credit sales


Factor
4. Pay the offered amount
3.Invoice
5.Request to pay
6. Payment
1. Sell services
2. Promise to pay
Seller
Buyer

FEE BASED ADVISORY SERVICE

(i) **Merchant Banking:** Fee based advisory services includes all these financial services rendered by Merchant Bankers. Merchant bankers play an important role in the financial services Sector. The Industrial Credit and Investment Corporation of India (ICICI) was the first development finance institution to initiate such service in 1974. These include banks financial institutions, non - banking financial companies (NBFCS), brokers and so on. Financial Services provided by these organizations include loan syndication portfolio management, corporate counselling project counselling debenture trusteeship, mergers acquisitions.

FEE BASED ADVISORY SERVICE



Merchant Banking act as Financial Engineer for a Business.

FEE BASED ADVISORY SERVICE

(ii) **Credit Rating:**

Credit rating is the opinion of the rating agency on the relative ability and willingness of the issuer of debt instrument to meet the debt service obligations as and when they arise. As a fee based financial advisory service, credit rating useful to investors, corporates (borrowers), banks and financial institutions. For the investors, it is an indicator expressing the underlying credit quality of a (debt) issue programme. The investor is fully formed about the company as any effect of changes in business/ economic conditions on the agency company is evaluated and published regularly by the rating agency

FEE BASED ADVISORY SERVICE

(iii) **Stock - Broking** Prior to the setting up of SEBI, stock exchanges were being supervised by the Ministry of Finance under the Securities Contracts Regulation Act (SCRA) and were operating more or less self-regulatory organizations. The need to reform stock exchanges was felt, when malpractices crept into Trading and in order to protect investor's interests, SEBI was set up to ensure that stock exchange perform their self - regulatory role properly. Since then, stock broking has emerged as a professional advisory service Stockbroker is a member of a recognized stock exchange who buys, sells or deals in shares/ securities. It is mandatory for each stockbroker to get him/ herself registered with SEBI order to act as a broker. SEBI is empowered to impose conditions while granting the certificate of registration

Distinguish between Money Market and Capital Market

Money market Capital market	Money market Capital market
1. Short term funds	1. Long term funds
2. Operational/WC needs	2. FC/PC requirements
3. Instruments are: bills, CPs, T-bills, CDs etc.,	3. Shares, debentures, bonds etc., are main instruments in capital market
4. Huge face value for single instrument	4. Small face value of securities
5. Central and coml. banks are major players	5. Development banks, investment institutions are major players
6. No formal place for transactions	6. Formal place, stock exchanges
7. Usually no role for brokers	7. Brokers playing a vital role