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Module 1: Overview of Indian Financial System

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A system in an engineering sense is a set of different components put together to perform the certain tasks. In a similar manner, one can understand the financial system, that comprises different components in the economy to perform certain financial activities.

In the economy, there are two sectors.

- First one is **surplus sector** that comprises individual or business entities who want to invest their savings (surplus money).
- The second sector is **deficit sector** that comprises individual or business entities who seek the money or want to borrow money.

A **financial system** is the link between surplus and deficit sectors.

1.1 Features of Indian Financial Systems

A financial system plays a significant role in the economic growth of a country by mobilizing the surplus funds and utilizing them effectively for productive purposes.

The role of financial system in the economy of the country can be featured through following points.

- It encourages both savings and investment.
- It links savers, investors and borrower.
- It helps in capital formation.
- It helps in allocation of risk.
- It facilitates expansion of financial markets.

1.2 Components of Financial System

A financial system is composition of Institutions, Markets, Laws and Regulations, Financial Services, Transactions etc.

So broadly speaking, a financial system consists of four major components:

- Financial Institutions
- Financial Instruments
- Financial Markets
- Financial Services

1.3 Financial Institutions

- Financial institution is the intermediary that facilitates smooth functioning of the financial system by making investors and borrowers meet productive activities that promises a better rate of return.
- They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return.
- Also, they offer various services such as plan for restructuring of debt to diversification of investments to individuals or business entities and even to the government.

Financial institutions can be classified into two categories:

- Banking Institutions.
- Non - Banking Financial Institutions.

1.3.1 Banking Institutions

Indian banking industry is subject to the control of the Central Bank. The Reserve Bank of India (RBI) as the apex institution organizes, runs, supervises, regulates and develops the monetary system and the financial system of the country.

The main legislation governing commercial banks in India is the **Banking Regulation Act, 1949.**

Indian Banking Institutions are categorized into two sectors,

(a) Organized Sector-Institutions that come directly or indirectly under the regulations of the RBI constitute the organized sector.

(b) Unorganized Sector-Institutions that does not come under purview of the central banking regulations.

Organized vs Unorganized Financial Institutions:

The organized sector consists of the RBI, commercial banks, financial intermediaries such as the Life Insurance Corp. of India, Credit and Investments Corporation of India, Unit Trust of India, Land Mortgage Banks, Cooperative Banks, Insurance Companies etc.

The unorganized sector is largely made up of indigenous bankers, money lenders, traders, commission agents etc., some of whom combine money lending with trade and other activities.

1.3.1.1 Organized Banking Institutions

The organized banking sector consists of

A Commercial banks

B Cooperative banks

C Regional rural banks

D Foreign banks.

(A) Commercial Banks

The commercial banks may be scheduled banks or non-scheduled banks. RBI is the highest monetary authority in the country. It makes rules and regulations for the scheduled commercial banks in India

- Scheduled Banks–These are banks that have been included in the **Schedule-II of the RBI Act, 1934**. The banks included in this category should fulfill two conditions:
  (i) The paid up capital and collected fund of the bank should not be less than Rs. 5 lac.
  (ii) Any activity of the bank will not adversely affect the interests of the depositors.
- Non-scheduled Banks–The banks that are not included in the list of the scheduled banks are called the Non- Scheduled Banks.

(B) Co-operative banks

An important segment of the organized sector of Indian banking is the co-operative banking.

The segment is represented by a group of societies registered under the Acts of the states relating to co-operative societies.

In fact, co-operative societies may be credit societies or non-credit societies.

Note that, A credit co-operative society formed by the a group of people of the same class to fulfill economic requirements. Such society is jointly owned and controlled such people democratically.

Different types of co-operative credit societies are operating in Indian economy. These societies can be further classified into two broad categories: (a) Rural credit societies which are primary agriculture, (b) Urban credit societies which are primarily non-agriculture.

(C) Regional Rural Banks (RRB)

Regional Rural Banks (RRB) were set by the state government and some commercial banks (sponsoring banks) with the **objective of developing the rural economy**.

The regional rural banks were set up with a view to provide credit facilities to weaker sections.

Regional rural banks provide banking services and credit to farmers and small entrepreneurs in the rural areas.

There were – 06 RRBs in 1975, 107 RRBs in 1981, 196 RRBs in 2002. Currently there are 43 major RRB's in India as per official website of Dept. financial services of India.

(D) Foreign Banks

Foreign banks have been in India from British days.

As name implies, these are banks of different countries performing banking operations in India.

They have head office in their home country while they may have branches in other countries

With the deregulation (Elimination of Government Authority) in 1993, large number of foreign banks are entering India.

e.g Foreign Banks are: Citi Bank. HSBC Bank, Bank of Ceylon etc.

1.3.1.2 Unorganized Banking Institutions

(A) Indigenous Bankers

Indigenous Bankers are private firms or individual who operate as banks and as such both receive deposits and given loans.

Like bankers, they are also financial intermediaries.

They should be distinguished professional money lenders whose primary business is not banking and money lending.

The indigenous banks are trading with the Hundies, Commercial Paper.

(B) Money Lender

Money lenders depend entirely on their own funds.

Money Lenders may be rural or urban, professional or non-professional such as farmers, merchants, traders.

Their operations are entirely unregulated and they charge very high rate of interest.

1.3.2 Non-Banking Financial Institutions

- NBFI don't work under Banking Regulation Act, but they work under Companies Act.
- They are not part of credit and settlement systems unlike Banking Institutions (BI).
- They are not allowed to receive Demand Deposits (Deposits that can be withdrawn on demand) from public unlike BI.
- They can not create a credit unlike banks.
- They dont have to maintain specified cash reserve ratio and statutory liquidity ratio unlike banks.
- Foreign investments up to 100% is possible unlike BI (private only), where this can be only 74%.

1.4 Financial Instruments

Financial instruments are documents/certificate (may be in electronic form) that represent financial claims on assets.

They assures a claim of the repayment of a invested sum of money at the end of a specified period together with interest or dividend if applicable. Therefore, the are also called as financial securities.

There are two categories of financial securities,

- Primary or Direct securities.

  - Secondary or Indirect securities.

- Primary Securities: These are securities directly issued by the ultimate borrower to the ultimate investor.

  For example, shares and debentures issued directly to the public.

- Secondary Securities: These are securities issued by some financial intermediaries to the ultimate savers (investor).

  For example, Unit Trust of India and mutual fund houses issue securities in the form of units to the public and the money pooled is invested in companies.

Based on the duration, they can also be classified as,

- Short-term securities for period less than 1 year.
- Medium term securities for period of 1 year to 5 years.
- Long - term securities for period of 5 years or more.

1.5 Financial Markets

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

In other words, financial markets are marketplace where the trading of securities occurs. For example, stock market, bond market, forex market, derivatives market etc.

Financial markets plays vital role in smooth operation of market based economies.

Functions of financial markets are,

- To facilitate creation and allocation of credit and liquidity.
- To serve as intermediaries for mobilization of savings.
- To assist the process of balanced economic growth.
- To provide financial convenience.
- It caters to the various credit needs of the business houses.

Financial markets are broadly classified into two types,

(A) Capital Market

(B) Money Market

(A) Capital Market

The capital market is a market for financial assets that have a long or indefinite maturity.

Generally, it deals with long term securities, which have a maturity period of above one year.

Capital market may be further divided into three categories,

(a) Industrial securities market.

(b) Government securities market.

(c) Long-term loans market.

(a) Industrial Securities Market:

As the name suggests, it is a market for industrial securities.

It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments such as equity shares (or ordinary shares), preference shares, debentures or bonds.

It can be further subdivided into two. They are:

(i) Primary market or New issue market

(ii) Secondary market or Stock exchange

Primary Market

- Primary market or New Issue market is a market for new issues or new financial claims.
- It deals with those securities which are issued to the public for the first time.
- In the primary market, borrowers exchange new financial securities for long term Investment of funds.
- Thus, primary market facilitates capital formation
- There are three ways by which a company may raise capital in a primary market.
  - *Public Issue:* This is the most common method of raising capital by new companies is through sale of securities to the public.
  - *Right Issue:* When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a preemptive basis, then such issue is called as Right Issue.
  - *Private Placement:* This is a way of selling securities privately to a small group of investors.

Secondary Market

- In the secondary market, securities which have already issued through the 'new issue market' are traded.
- Usually securities are traded through the Stock Exchange.
- So this market consists of all stock exchanges recognized by the Government of India.
- The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act 1956, and
- Securities and Exchange Board of India (SEBI) regulates them.
- Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) are two principle stock exchanges of India.

(b) Government Securities Market :

- It is a market where Government securities are traded.
- In India long term securities are traded in this market. (short term securities are traded in the money market).
- Securities are issued by the Central Government, State Governments, Semi Government authorities like City Corporations, Port Trusts etc.
- Note that, funds which invests in the government securities are called as Gilt funds. So often such market is called as Gilt-Edged securities market.

(c) Long-term Loans Market :

- Development banks and commercial banks play a key role in this market by providing a long term loans to corporate customers.
- Long term loans market may further be classified into:

  Term loans market: In India, many industrial financing institutions have been created by the Government both at the national and regional levels to supply medium and long term loans to corporate customers.
  These development banks dominate the industrial finance in India. e.g. IDFC (Infrastructure Development Finance Company), IFCI (Industrial Finance Corporation of India), ICICI bank etc.

  Mortgages market: A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage. This mortgage may be equitable mortgage or legal one.

Financial Guarantees market: A financial guarantee is a contract by a third party (guarantor) to back the debt of a second party (the creditor) for its payments to the investor.

(B) Money Market

- Money market is a market, which deals with financial short term assets and securities.
- The money market may be subdivided into four categories,
  (a) Call money market
  (b) Commercial bills market
  (c) Treasury bills market
  (d) Short term loan market

(a) Call Money Market

- The call money market is a market for very short period loans say one day to fourteen days.
- The loans are repayable on demand of either the lender or the borrower.
- So liquidity of investment is very high.
- Another feature of this market is its volatility. i.e. It is very sensitive to changes in demand and supply of call loans.
- So the interest rate varies day to day. It even hour to hour from Centre to Centre.
- In India, call money markets are associated with the presence of stock exchanges and hence they are located in major industrial towns like Bombay, Calcutta, Madras, Delhi, Ahmedabad etc.

(b) Commercial Bills Market

- Bill Market is the market for short-term bills generally of three months maturity.
- A bill is a promise to pay a specified amount by the borrower (drawer) to the creditor (drawee).
- Bills are of three types
  - Bills of exchange or commercial bills used to finance trade.
  - Finance bills or promissory notes.
  - Treasury bills used to meet temporary financial needs to the government.
- These bills may be bought and sold in the discount market which consists of Commercial Banks, Discount Houses etc.

(c) Treasury Bills Market

- It is a market for treasury bills which have ' short-term ' maturity.
- A treasury bill is a promissory note or a finance bill issued by the Government.
- It is highly liquid because its repayment is guaranteed by the Government.
- It is an important instrument of the Government for the short term borrowing.
- There are two types of treasury bills, one is **ordinary or regular** treasury bills that are issued to the public or banks etc. and second one is **ad hoc** treasury that is issued to RBI only.

(d) Short term loan market

- It is a market where short term loans are given to corporate customers for meeting their working capital requirements.
- Commercial banks play a significant role in this market. They provide short term loans in the form of cash credit and overdraft.
- Over draft facility is mainly given to business people whereas cash credit is given to industrialists.
- Overdraft is purely a temporary accommodation and it is given in the current account itself.
- However, cash credit is for a period of one year and it is sanctioned in a separate account.

1.6 Financial Sevices

- Efficiency of financial system is largely dependent on the quality and variety of financial services provided by financial intermediaries.
- Financial service industry mainly comprises banks, financial institutions and non-banking financial companies.
- The term financial services can be defined as activities" that is connected with the financial goods offered to the customers.
- According to the finance and **Development Department** of the International Monetary Fund (**IMF**), financial services are the processes by which consumers or businesses acquire financial goods.
- Professional Advisory, Wealth Management, Mutual Funds, Insurance, Stock Market, Treasury/Debt Instruments, Tax/Audit Consulting.

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