08. 11. 20

Indian Financial System

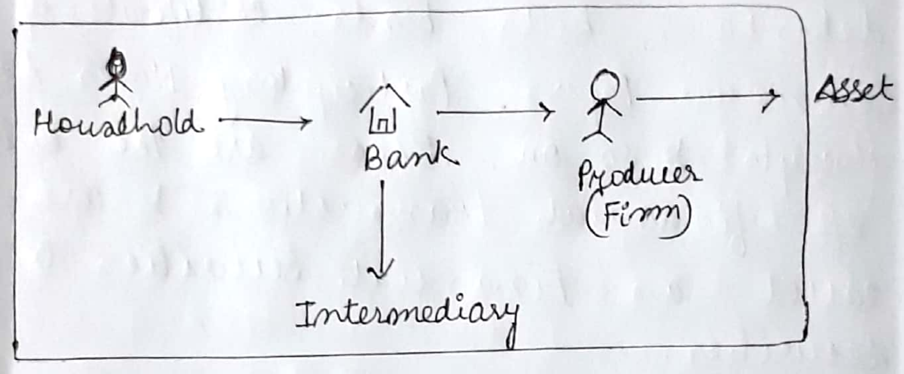
Some Basic Terms ⇒

Saving = (Income – Expenditure)

Finance

Capital

Investment

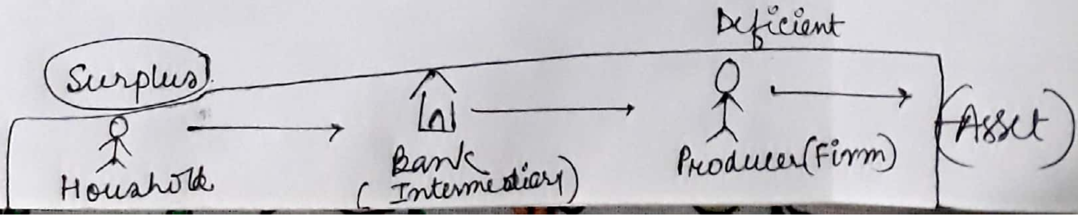


Financial System

An integration of financial entities, financial instruments, financial markets & the financial regulators which provides a framework for movement of funds from funds surplus entities like investors to the fund deficient entities like producers

Financial System

- Entities
- Instruments
- Market
- Regulator



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Financial Entities are the investors, lenders, borrowers, farmers, producers, intermediaries etc. acting in individual or firm capacity.

Financial Instruments include shares, debentures, bills, bonds, certificates of Deposits, Commercial Papers, Participatory Notes, Depository Receipts & so on. These are the evidences of financial transactions & are also called as Financial Securities or just Securities.

Financial Market refer to the system of contract between lenders & borrowers or other parties & include Money Market as well as Capital Market.

Financial Regulators are the agencies that control the working of financial system & includes RBI, SEBI, NABARD, IRDA, PFRDA, & so on

Mains Question
↓
Problem with multiple regulators
→ UFRA

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Domains of Financial System

There are several domains of Financial Sector including —

1. Agricultural Credit
2. Industrial Finance
3. Public Finance
4. Consumer / Retail Finance
5. International Finance.
6. Micro - Finance
7. Infrastructural Finance
8. Export Credit
9. Mutual Fund
10. Insurance Sector & so on.

Financial Markets

Financial Markets can be sub-divided into —

1. Money Markets (<1 yr)
2. Capital Markets (≥ 1 yr)

Money Markets provide short term funds for a period less than 1 yr. e.g. in banking sector, banks borrow money to maintain liquidity. Capital Markets provide long term funds for a period of 1 yr or

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more & they can be classified as —

Primary & Secondary Capital Markets.

Money Markets in India →

Unorganised Money Markets have existed in India for centuries & its was Chakravarty Committee which highlighted the need for an organised money market in India. In 1987 a working group headed by N. Vaghul prepared the blueprint for the organised money market in India. After 1991, several money market instruments were introduced including the following —

1. Treasury Bills (T Bills → 14, 91, 184, 364 days credit) which are issued by Govt. for meeting short term requirements.

2. C- Bills → Commercial Bills — that are issued by the Financial Institutions & companies to borrow short term money.

3. Certificates of Deposits which are issued by banks, financial institutions & companies to borrow

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for short terms.

4. Commercial Papers which are issued by the Corporate Sector for short term borrowing.

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Money & Monetary Aggregates

Anything which is generally acceptable as a common medium of exchange, measure & store of value can be termed as Money.

If money has its own intrinsic value as in case of gold, precious stone then it is called as "Commodity Money," but when value is derived by legislation then it can be called "Fiat Money" or "Legal Tender Money"

The close substitute of currency such as cheques, demand drafts, pay orders debit & credit cards are sometimes called "Near Money". A digital currency which can be created & stored electronically in Blockchains is called "Virtual Money"/Currency or "Crypto currency" e.g. Bitcoin, Lite coin, Name coin, Ethereum & so on.

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The value of Money can be described in terms of foreign currency like dollar & is called "Forex Rate" or in terms of commodity prices when it is called as "Purchasing Power of currency." People demand currency & different forms of money for the purpose of making transactions or keeping for emergencies while the supply of Money is ensured by the central Bank i.e. RBI in India.

The Monetary Policy in India is based on certain monetary aggregates that measure the total stock & supply of Money.

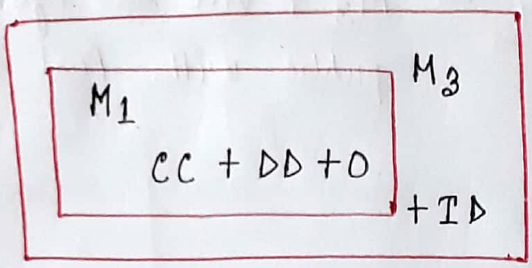
Some popular monetary aggregates are as follows :→

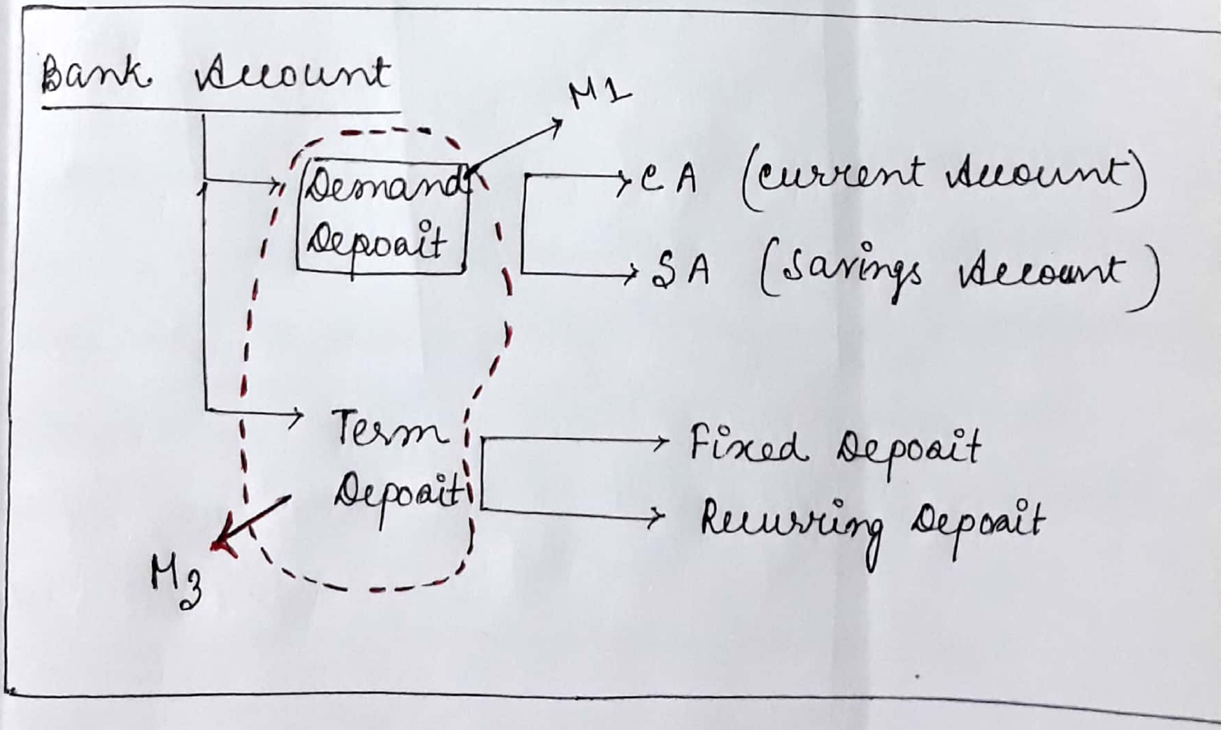
1. Reserve Money (M_0) which is the total currency in circulation + Banker's deposits with RBI + Deposits of other institutions with RBI. (CiC + RBI)
It is most liquid & is called as "High Powered Money"

2. Narrow Money (M_1) which refers to the currency & coins held by Public + Demand deposits of public with Banks + other deposits

with RBI $\longrightarrow$ $(CC + DD + O)$

(3) <u>Broad Money (M_3)</u> which is the sum of M_1 & term deposits of public with Banks $(M_1 + TD)$





4) $\underline{M_2}$ = M_1 + Saving deposits of Public with Post-offices.

5) $\underline{M_4}$ = M_3 + All savings & term deposits of public with Post Offices.

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CAPITAL

Long term funds or finance available for a period of 1 year or more is called the Capital. In a different context funds invested in business is also called Capital.

Capital of a business can be divided into 2 parts —

a) Borrowed Capital also called "Debt"

b) Owner's Capital also called "Equity"

Companies divide large Debt into numerous small pieces called Debentures which are issued to Public as "Financial Instruments"

Similarly, equity can be divided into large no. of Shares & issued to investors or owners.

Capital
→ Debt (Lenders)
1 crore Debentures @ 100/
→ Equity (Owners/Investors)
1 crore shares @ 100/

Capital is invested in different forms of assets like buildings, Equipments

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machineries, softwares, furnitures & so on.

These are collectively called the Assets of the Company which may be tangible or intangible. The statement of Assets & Liabilities is called "Balance Sheet"

Balance Sheet

Liabilities	Asset
Capital → Equity → Debt Others - - - -	Assets → Fixed → Working (current)

Net worth of a company → Market value of Assets less outsiders liabities.

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Balance Sheet of a Bank

Liabilities	Assets
CAPITAL → Equity (↑) → Debt (↓)	**LOANS** → PA → NPA
Deposits → DD → TD	

Liquidity v/s Solvency

Ability to meet short term financial obligation is called liquidity. e.g. money required to pay financial expenses & operating expenses.

Ability to pay long term financial obligations is called Solvency.

Insolvency

Inability to pay long term financial obligation is called Insolvency.

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Bankruptcy

It is a condition in which an insolvent person surrenders assets to a legal authority for administration

Bond v/s Bill

Long term financial instrument issued by the borrower without keeping any collateral asset as mostly we see in case of govt. loans is called a Bond. (with collateral asset it is called Debenture)

In short period, such instruments are called "Bills."

There are different ~~tp~~ types of Bonds & Bills which are popular.

e.g.
Masala Bonds, Elephant Bond,
Treasury Bills, Sovereign Gold Bonds, Green Bonds

- Masala Bond is dominated in Rupees & issued to foreign investors by an Indian company. There is no forex risk for the Indian company.

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Masala Bond

2020 $1 — ₹ 75 m

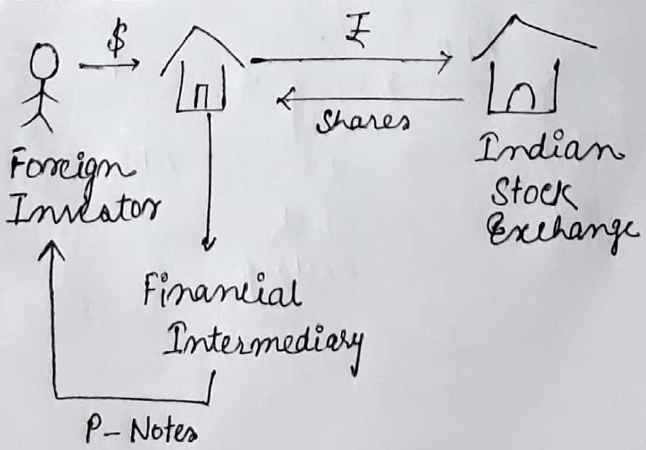
2030 $2 — $\boxed{150 \times 2}$

₹ 300 m

It is acceptable to foreign investors to bear the forex risk because the interest rate in India is much higher.

Elephant Bond is a Sovereign Bond issued by govt. to those who declared their Black Money under tax Amnesty with the condition of investing a significant part in infrastructure development of the country.

Participatory Notes (P-Notes)



P-Note is a derivative financial instrument which is issued to a foreign investor by a registered financial institution against Indian financial security.

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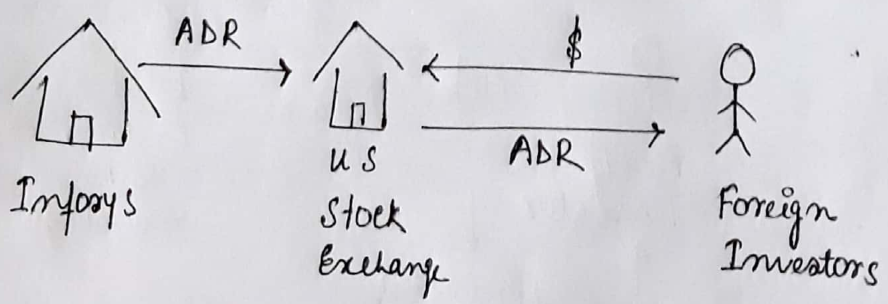
~~con~~ convenient

It is a ~~convenient~~ method for investing for the foreign investors but misused for Money Laundering. The basic reason is that the investor is anonymous.

A better substitute of P-Note is the Depository Receipt which is issued to a registered holder. e.g. Infosys was the 1st Indian Company to issue American Depository Receipts (ADR) in the U.S. Stock Market. Similarly, foreign companies can issue Indian Depository Receipts (IDR) to the Indian Investors for mobilising funds.



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