UNIT-I: : Introduction to Financial System and Financial Services

Meaning, Features, Functions and Classification. Financial Services- Concept, Meaning, Scope, Growing importance of financial services in financial system–Classification–Traditional and Modern view–Fund based and non fund based services–Financial engineering–Need for innovation–New financial products and services–An overview of Indian financial services sector scenario and Challenges facing Financial Service

Meaning, Features, Functions and Classification. Financial Services-

Introduction:

Financial service is part of financial system that provides different types of finance through various credit instruments, financial products and services. In financial instruments, we come across cheques, bills, promissory notes, debt instruments, letter of credit, etc.

In financial products, we come across different types of mutual funds. Extending various types of investment opportunities. In addition, there are also products such as credit cards, debit cards, etc.

In services we have leasing, factoring, hire purchase finance etc., through which various types of assets can be acquired either for ownership or on lease. There are different types of leases as well as factoring too. Thus, financial services enable the user to obtain any asset on credit, according to his convenience and at a reasonable interest rate.

Importance of Financial services

It is the presence of financial services that enables a country to improve its economic condition whereby there is more production in all the sectors leading to economic growth.

The benefit of economic growth is reflected on the people in the form of economic prosperity wherein the individual enjoys higher standard of living. It is here the financial services enable an individual to acquire or obtain various consumer products through hire purchase. In the process, there are a number of financial institutions which also earn profits. The presence of these financial institutions promote investment, production, saving etc. Hence, we can bring out the importance of financial services in the following points:

1. Minimizing the risks

The risks of both financial services as well as producers are minimized by the presence of insurance companies. Various types of risks are covered which not only offer protection from the fluctuating business conditions but also from risks caused by natural calamities. Insurance is not only a source of finance but also a source of savings, besides minimizing the risks. Taking this aspect into account, the government has not only privatized the life insurance but also set up a regulatory authority for the insurance companies known as IRDA, 1999 (Insurance Regulatory and Development Authority) .

2. Maximizing the Returns

The presence of financial services enables businessmen to maximize their returns. This is possible due to the availability of credit at a reasonable rate. Producers can avail various types of credit facilities for acquiring assets. In certain cases, they can even go for leasing of certain assets of very high value.

Factoring companies enable the seller as well as producer to increase their turnover which also increases the profit. Even under stiff competition, the producers will be in a position to sell their products at a low margin. With a higher turnover of stocks, they are able to maximize their return.

3. Ensures greater Yield

As seen already, there is a subtle difference between return and yield. It is the yield which attracts more producers to enter the market and increase their production to meet the demands of the consumer. The financial services enable the producer to not only earn more profits but also maximize their wealth.

Financial services enhance their goodwill and induce them to go in for diversification. The stock market and the different types of derivative market provide ample opportunities to get a higher yield for the investor.

4. Economic growth

The development of all the sectors is essential for the development of the economy. The financial services ensure equal distribution of funds to all the three sectors namely, primary, secondary and tertiary so that activities are spread over in a balanced manner in all the three sectors. This brings in a balanced growth of the economy as a result of which employment opportunities are improved.

The tertiary or service sector not only grows and this growth is an important sign of development of any economy. In a well developed country, service sector plays a major role and it contributes more to the economy than the other two sectors.

5. Economic development **Financial services enable the consumers to obtain different types of products and services by which they can improve their standard of living. Purchase of car, house and other essential as well as luxurious items is made possible through hire purchase, leasing and housing finance companies. Thus, the consumer is compelled to save while he enjoys the benefits of the assets which he has acquired with the help of financial services.**

6. Benefit to Government

The presence of financial services enables the government to raise both short-term and long-term funds to meet both revenue and capital expenditure. Through the money market, government raises short term funds by the issue of Treasury Bills. These are purchased by commercial banks from out of their depositors' money.

In addition to this, the government is able to raise long-term funds by the sale of government securities in the securities market which forms apart of financial market. Even foreign exchange requirements of the government can be met in the foreign exchange market. The most important benefit for any government is the raising of finance without offering any security. In this way, the financial services are a big boon to the government.

7. Expands activities of Financial Institutions

The presence of financial services enables financial institutions to not only raise finance but also get an opportunity to disburse their funds in the most profitable manner. Mutual funds, factoring, credit cards, hire purchase finance are some of the services which get financed by financial institutions.

The financial institutions are in a position to expand their activities and thus diversify the use of their funds for various activities. This ensures economic dynamism.

8. Capital Market

One of the barometers of any economy is the presence of a vibrant capital market. If there is hectic activity in the capital market, then it is an indication of the presence of a positive economic condition. The financial services ensure that all the companies are able to acquire adequate funds to boost production and to reap more profits eventually.

In the absence of financial services, there will be paucity of funds which will adversely affect the working of companies and will only result in a negative growth of the capital market. When the capital market is more active, funds from foreign countries also flow in. Hence, the changes in capital market is mainly due to the availability of financial services.

9. Promotion of Domestic and Foreign Trade

Financial services ensure promotion of domestic as well as foreign trade. The presence of factoring and forfeiting companies ensures increasing sale of goods in the domestic market and export of goods in the foreign market. Banking and insurance services further contribute to step up such promotional activities.

10. Balanced Regional development

The government monitors the growth of economy and regions that remain backward economically are given fiscal and monetary benefits through tax and cheaper credit by which more investment is promoted. This generates more production, employment, income, demand and ultimately increase in prices. The producers will earn more profits and can

expand their activities further. So, the presence of financial services helps backward regions to develop and catch up with the rest of the country that has developed already.

Classification–Traditional and Modern view–Fund based and non fund based services–

Financial services a wide range of activities. They can be broadly classified into two.

1. Traditional activates
2. Modern activates

Traditional Activates: Financial intermediates have been rendering a wide range of services encompassing both capital and money marketing activities. They can be grouped under 2 categories.

a. Fun based activities
b. Non fun based activates

a. Fund based services

Working Capital Financing:

A firm's working capital is the money available to meet current obligations (those due in less than a year) and to acquire earning assets. Chinatrust Commercial Bank offers corporations Working Capital Finance to meet their operating expenses, purchasing inventory, receivables financing, either by direct funding or by issuing letter of credit.

Key Benefits

- Funded facilities, i.e. the bank provides funding and assistance to actually purchase business assets or to meet business expenses.
- Non-Funded facilities, i.e. the bank can issue letters of credit or can give a guarantee on behalf of the customer to the suppliers, Government Departments for the procurement of goods and services on credit.
- Available in both Indian as well as Foreign currency.

Short Term Financing

The bank can structure low cost credit programmes and cash flow financing to meet your specific short-term cash requirements. The loans are structured to enhance your profitability by scheduling the repayment to match the cash flow available to repay the debt.

Bill Discounting

Bill discounting is a short tenure financing instrument for companies willing to discount their purchase / sales bills to get funds for the short run and as for the investors in them. These are customized to suit your requirement for short-term finance, from the date of sale to the date of receipt of payment there on. We consider two types of bills facility viz. where documents are delivered on payment, i.e. D/P Bills and where the documents are delivered against acceptance i.e. D/A Bills.

Export credit

We offer short-term working capital finance both at the pre-shipment and post-shipment stages .Pre-shipment finance facility provides liquidity for procuring raw materials, processing, packing, transporting, meant for export.

Post-shipment finance is a credit facility extended from the date of shipment of goods till the realization of the export proceeds. The different types of post-shipment advances include:

Structured finance

Structured Finance describes any "non-standard" way of raising money. These tailor-made securities go beyond "standard" securities like conventional loans, debentures, debt, and equity. The reason to structure a more advanced security may be that conventional securities may be unattractive, unavailable or too expensive. These products are structured for both long and short tenor with exit options at intervals for both parties.

● **Term Lending**

CTCB offers very competitive rates for term financing. We also provide advisory services to companies for syndication of the term loans to a wide spectrum of financial institutions.

Under Term Finance, **China trust Commercial Bank**, offers the following:

- Fund Based Finance for capital expenditure acquisition of fixed assets towards starting or expanding a business to swap with high cost existing debt from other bank / financial institution
- Non-Fund Based Finance in the form of Deferred Payment Guarantee for acquisition of fixed assets towards starting / expanding a business or industrial unit.

b. Non-Fund Based Services

Letters Of Credit

Letter of credit is a legal document issued by a buyer’s bank that upon presentation of required documents payment would be made. Usually confirmed by the seller's bank, protection is given to the seller that payment will be made if the goods are shipped correctly, following the conditions laid down when the LC is opened or based on subsequent amendments and protection is given to the buyer that the goods will be shipped before payment is made.

The LC facility can be granted to the importers after assessing their requirement/ credit worthiness/ financial strength and other parameters being to the satisfaction of the Bank.

China trust Commercial Bank can extend Import financing through Letters of Credit, which are well accepted globally and are supported by a strong trade finance set-up. We are direct members of SWIFT and have correspondent banking arrangements with many banks worldwide.

Bank Guarantees

Bank Guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default. China trust Commercial Bank sanctions Bank Guarantee limit to facilitate issue of guarantees on behalf of its clients. Various types of guarantees offered are – financial, performance, bid bond, tenders, customs, etc. Our guarantees are accepted by all government agencies including Customs, Excise, Insurance Companies, Shipping Companies, all Capital Market Agencies such as NSE, BSE, ASE, CSE etc. and all major corporates.

Collection Of Documents

We have a full-fledged trade finance set-up catering to all your trade related requirements, which offers you the following advantages:

1. Better turnaround time through timely processing of your documents
2. Facilitating faster payments
3. Lower cost
4. Excellent trade support
5. Arrangement of credit reports of overseas parties

Specialized advice on international trade related issues as well as technical issues such as Exchange Control requirements, RBI reporting, latest circulars and latest international developments.

2. Modern Activities

Beside the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been in brief under the head 'New financial products and services'. However, some of the modern services provided by them are given in brief hereunder.

Financial engineering

Financial engineering is a multidisciplinary field involving financial theory, methods of engineering, tools of mathematics and the practice of programming. It has also been defined as the application of technical methods, especially from mathematical finance and computational finance, in the practice of finance. Despite its name, financial engineering does not belong to any of the fields in traditional professional engineering even though many financial engineers have studied engineering beforehand and many universities offering a postgraduate degree in this field require applicants to have a background in engineering as well. In the United States, the Accreditation Board for Engineering and Technology(ABET) does not accredit financial engineering degrees. In the United States, financial engineering programs are accredited by the *International Association of Quantitative Finance*.

Financial engineering draws on tools from applied mathematics, computer science, statistics and economic theory. In the broadest sense, anyone who uses technical tools in finance could be called a financial engineer, for example any computer programmer in a bank or any statistician in a government economic bureau. However, most practitioners restrict the term to someone educated in the full range of tools of modern finance and whose work is informed by financial theory. It is sometimes restricted even further, to cover only those originating new financial products and strategies. Financial engineering plays a key role in the customer-driven derivatives business which encompasses quantitative modelling and programming, trading and risk managing derivative products in compliance with the regulations and Basel capital/liquidity requirements.

Why does financial innovation occur?

Economic theory has much to say about what types of securities should exist, and why some may not exist (why some markets should be "incomplete") but little to say about why new types of securities should come into existence.

One interpretation of the Modigliani-Miller theorem is that taxes and regulation are the only reasons for investors to care what kinds of securities firms issue, whether debt, equity, or something else. The theorem states that the structure of a firm's liabilities should have no bearing on its net worth (absent taxes, etc.). The securities may trade at different prices depending on their composition, but they must ultimately add up to the same value.

Furthermore, there should be little demand for specific types of securities. The capital asset pricing model, first developed by Jack L. Treynor and William F. Sharpe, suggests that investors should fully diversify and their portfolios should be a mixture of the "market" and a risk-free investment. Investors with different risk/return goals can use leverage to increase the ratio of the market return to the risk-free return in their portfolios. However, Richard Roll argued that this model was incorrect, because investors cannot invest in the entire market. This implies there should be demand for instruments that open up new types of investment opportunities (since this gets investors closer to being able to buy the entire market), but not for instruments that merely repackage existing risks (since investors already have as much exposure to those risks in their portfolio).

If the world existed as the Arrow-Debreu model posits, then there would be no need for financial innovation. The Arrow-Debreu model assumes that investors are able to purchase securities that pay off if and only if a certain state of the world occurs. Investors can then combine these securities to create portfolios that have whatever payoff they desire. The fundamental theorem of finance states that the price of assembling such a portfolio will be equal to its expected value under the appropriate risk-neutral measure.

Historical examples of financial innovation

Examples of spanning the market

Some types of financial instrument became prominent after macroeconomic conditions forced investors to be more aware of the need to hedge certain types of risk.

- The development of interest rate swaps in the early 1980s after interest rates skyrocketed.
- The development of credit default swaps in the early 2000s after the recession beginning in 2001 led to the highest corporate-bond default rate in 2002 since the Great Depression.

Examples of mathematical innovation

- The market in options exploded after the development of the Black–Scholes model in 1973.
- The development of the CDO was heavily influenced by the popularization of the copula technique (Li 2000).
- Flash trading exists since 2000 at the Chicago Board Options Exchange and 2006 in the stock market. In July 2010, Direct Edge became a U.S. Futures Exchange. Nasdaq and Bats Exchange, Inc created their own flash market in early 2009.