The Indian financial system: An introduction

Introduction

- Financial system is a complex, well-integrated set of sub-systems of financial institutions, markets, regulators and services which facilitate the transfer and allocation of funds effectively and efficiently.
- **Financial dualism:** coexistence and cooperation between formal and informal financial sectors
- **Formal financial sector:** organised, institutional and regulated system which caters to the financial needs of the modern spheres of the economy
- **Informal financial sector:** unorganised, non-institutional and non-regulated system dealing with traditional and rural spheres of the economy
- **In India:**
    - **Formal financial sectors –** comes under the MoF (ministry of finance), RBI (reserve bank of India), SEBI (securities and exchange board of India) and other regulatory bodies
    - **Informal financial sectors –** individual money lenders, groups operating as “associations”, partnership firms consisting of “local brokers”, “pawn brokers” etc.

Components of formal financial system

- **Financial institutions**
    - Intermediaries that mobilises savings and facilitates allocation of funds in efficient manner
    - Resort to financial markets for raising funds
    - Classification: (remember one example each)
        - Banking institutions (commercial and cooperative banks)
        - Non-Banking institutions (NBFC’s)
        - Term finance institutions (ICICI)
        - Specialised institutions (EXIM)
        - Sectorial institutions (NABARD)
        - Investment institutions (LIC)
        - State level institutions (SIDC’s)
- **Financial markets**
    - Enables participants to deal in financial claims
    - Their demands and requirements interact to set a price for these claims
    - Divided in terms of types:
        - Money market – short term securities
        - Capital market – long term securities (maturity period of 1 year or more)
    - Divided in terms of segments:
        - Primary market – deals with new issues
        - Secondary market – deals with existing securities
- **Financial instruments**
    - It is a claim against a person or an institution for payment, at a future date of a sum of money and/or periodic payment in the form of interest or dividend
    - Channelizes funds from lenders to borrowers
    - Like paper wealth shares, debentures like bonds or notes
    - Marketable – denominated in small amounts and traded in organized markets – **advantage**
    - Enabled people to hold a portfolio of different assets which help reducing risk – **advantage**
    - They are tailor made – can be designed to suit the risk and return preferences of different classes of investors – **advantage**

- **Types:**
    - Primary securities – direct securities as they are directly issued by the ultimate borrower of funds to the ultimate savers; include equity shares and debentures
    - Secondary securities – indirect securities as they are issues by financial intermediaries (institutions) to the ultimate savers; include mutual funds, insurance policies and bank deposits

- **Financial services**
  - Financial services are vital for creation of firms, industrial expansion and economic growth
  - These services aid:
    - Borrowing and funding
    - Investing and lending
    - Buying and selling securities
    - Payments and settlements
    - Managing risk
  - These services are categorized as:
    - **Funds intermediation and Payments mechanism** – link the borrower and lender; results in capital formation; technology aids quick, safe and convenient transfer of funds and settlement transactions
    - **Provision of liquidity** – essential for smooth functioning of financial system; enhanced through trading in securities; brokers assist sellers and buyers
    - **Risk management** – risk is chance of loss; enables risk transfer and protection from risk; these services provide a platform for sellers who don't want this unwanted risk to transfer this risk to those buyers who will accept it; services include financial insurance that will protect investors, buyers and sellers from interest rate fluctuations and exchange rate risk
    - **Financial engineering** – presents opportunities for value creation; these services refer to process of designing, developing and implementing innovative solutions for needs in funding, investing and risk management
  - These services are provided by **financial institutions** like merchant banking, leasing, hire purchase and credit – rating
  - The intermediaries (institutions) bridge the gap between lack of knowledge on the part of investors, and the increasing sophistication of financial instruments and markets.
  - Financial services are regulated by financial regulators who assure that it is safe for investors to lend money / exchange securities for funds
  - These regulators (mainly RBI and SEBI) regulate the conduct of issuers of securities and the institutions to protect the interest of investors in securities and increase their confidence in markets; this in turn helps build and develop a financial system
  - **The RBI regulates the MONEY market; the SEBI regulates the CAPITAL market**

Interaction between components of financial system

- Do not function in isolation
- Financial institutions mobilise savings by issuing different types of financial instruments, which are traded in financial markets.
- To assure the safety of credit allocation process, these institutions acquire special financial services.
- Financial institutions transfer financial securities which makes financial markets larger, more liquid and diversified
- Financial institutions rely on financial markets to raise funds in times of need
- The evaluation of new complex financial securities require financial expertise which financial institutions provide through financial services

- Hence these components are:
  - **Inter-dependent**
  - **Interactive**
  - **Close links**
  - **Always competing with each other**

Functions of financial system

- Mobilise and allocate savings
- Monitor corporate performance
- Provide payment and settlement systems
- Spread price related information
- Lower the cost of transactions
- Promote the process of financial deepening and broadening
- Offer portfolio adjustment facility

Key elements of a well-functioning financial system

- A strong legal and regulatory environment
- Stable money
- Sound public finances and public debt management
- A central bank
- Sound banking system
- Information system
- Well-functioning securities market