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Indian Financial system

Pre nineties and post nineties overview:

An efficient articulate and developed financial system is indispensable for the rapid economic growth of any economy. The process of economic development is invariably accompanied by a corresponding and parallel growth of financial organizations. However, their institutional structure, operating policies, regulatory/legal framework differ widely and largely influenced by the prevailing politico-economic environment. Planned economic development in India had greatly influenced the course of financial development. The liberalization /deregulation /globalization of the Indian economy since the early nineties have had important implications for the future course of development of the financial system. The evolution of the Indian financial system falls, from the viewpoint of exposition, into three distinct phases.

(i) Up to 1951, corresponding to the post – independence scenario, on the eve of the initiation of planned economic development.
(ii) Between 1951 and the mid-eighties reflecting the imperatives of planned economic growth, and
(iii) After the early nineties responding to the requirements of liberalized/deregulated /globalized economic environment.
(iv)
(v) A brief description of the three phases of Indian financial system is given below:

Phase I: Pre-1951 Organization

During the first phase, the organization of the financial system was immature and rudimentary, reflecting the under developed nature of the industrial economy of the country. It was incapable of sustaining a high level of capital formation and accelerated pace for industrial development.

Phase II: 1951 to Mid-Eighties

During the second phase, the mixed economy model with growing accent on ambitious industrialization programmed had a significant bearing on the evolution of the financial system and greatly conditioned the institutional structure and regulatory framework. The main elements of the financial organization in planned economic development could be categorized into four broad groups:

(i)Public/Government ownership of financial institutions.

(ii)Fortification of the institutional structure

(iii)Protection to investors

(iv)Participation of financial institutions in corporate management.

In brief, a unique financial system emerged in India by the mid-eighties in conformity with the requirements of planning and the dominant role of the government in the Indian economy.

Phase III: Post Nineties

With the liberalization /globalization of the economy, especially since the beginning of the nineties, the organization of the Indian financial system has been characterized by profound transformation.

The notable developments during this phase are with reference to-

(i)privatization of financial institutions,

(ii)re-organization of institutional structure and

(iii)Investor's protection

In brief, the role of the Government in the distribution of finance and credit is marked by a considerable decline and the Indian financial system is witnessing capital market-oriented developments. The capital market has emerged as the main agency for the allocation of resources. The essence of these developments is the fact that the Indian financial system is poised for integration with the savings pool in the domestic economy and abroad.

ORGANISATION STRUCTURE OF THE INDIAN FINANCIAL SYSTEM-MAJOR COMPONENT

The Indian financial system comprises financial institutions, financial markets, financial instruments and financial services that are continuously monitored by various regulatory authorities, namely, the Reserve Bank of India, Securities and Exchange Board of India and Insurance Regulatory and Development Authority. A description of the various components of the Indian financial system is given below:

1.**Financial Institutions**

These give a physical presence to the system and provide the financial infrastruc-ture. They encourage savings and make for its optimal allocation. They make one type of contract with the borrowers and another type with the lenders.
In other words, they perform the function of financial intermediation. The major financial institutions in India can be classified into Banking Institutions and Non-Banking Financial Institutions.

(i) **Banking Institutions**
These institutions mobilize the savings of 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. They are

commercial banks, cooperative banks and develop-mental banks. Commercial banks in India carry more than two-thirds of the assets of all financial institutions. Commercial banking can be further divided into four parts as follows:
I. Public sector banks
II. Private sector banks
III. Foreign banks
IV. Regional rural banks

(ii) Non-banking Institutions
Non-banking financial institutions (NBFIs) also mobilize financial resources directlyor indirectly from people. They lend funds but do not create credit. Companies such as LIC, GIC,UTI, Development Financial Institutions, Organization of Pension and Provident Funds fall into 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. The largest component of NBFIs, can be distinguished from banks with regard to the degree and nature of regulatory and supervisory controls. Firstly, the regulations governing these institutions are relatively lighter as compared to those of banks. Secondly, they are not subject to certain regulatory prescriptions applicable to banks. Some of the NBFIs are as discussed below.

i. Tourism Finance Corporation of India Ltd. (TFCI): The GoI had, pursuant to the recommendations of the National Committee on Tour-ism (i.e. the Yunus Committee set up under the aegis of Planning Com-mission), decided in 1988, to promote a separate All-India Financial Institution for providing financial assistance to tourism-related activities/projects.

ii. General Insurance Corporation (GIC): The entire general insur-ance business in India was nationalised by General Insurance Business(Nationalisation) Act, 1972 (GIBNA). The General Insurance Corpo-ration of India (GIC) was formed in pursuance of Section 9(1) ofGIBNA. It was incorporated on 22 November 1972 under the Compa-nies Act, 1956, as a private company limited by shares. GIC was formed for the purpose of superintending, controlling and carrying on the busi-superintending, controlling and carrying on the business of general insurance. It has a number of need-based insurance schemes to meet the diverse and emerging needs of various segments of society.

iii. Export-Import Bank of India (EXIM): Export-Import Bank of India is the premier export finance institution of the country, set up in 1982 under the Export–Import Bank of India Act, 1981. The Government of India launched the institution with a mandate, not only to enhance exports from India but also to integrate the country’s foreign trade and investment with the overall economic growth. For financing overseas investments, EXIM has put in place a Technology and Innovation Enhancement and Infrastructure Development (TIEID) for MSMEs by partnering with Banks/FIs.

iv. National Bank for Agriculture and Rural Development (NABARD): This is the apex institution in the country and it looksafter the development of the cottage industry, small industry and village industry, and other rural industries. NABARD also reaches out to allied economies and supports and promotes integrated development. Against the backdrop of the massive credit

needs of rural development and the need to uplift the weaker sections in rural areas, the National Bank for Agriculture and Rural Development was set up in 1982 under the National Bank for Agriculture and Rural Development Act 1981.

v. National Housing Bank (NHB): This was set up on 9 July 1988 under the National Housing Bank Act, 1987. It is wholly owned by the Reserve Bank of India, which contributed the entire paid-up capital. The Head Office of the NHB is in New Delhi. The NHB has been established to promote a sound, healthy, viable and cost-effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.

2. Financial Instruments

These instruments are another important constituent of the financial system. They represent a claim against the future income and wealth of others. It will be a claim against a person or an institution, for the payment of money at a specified future date. They fall into three broad categories - primary securities, indirect securities and derivatives.

(i) **Primary or direct instruments**

Primary instruments or direct securities are issued directly by borrowers to lenders. Equity shares, preference shares and debentures are primary securities. Equity shares are ownership securities and risk capital. The owners of such securities are residual claimants on income and assets and participate in the management of the company. Debentures are creditor-ship securities. Their holders are entitled to a specified interest and first claim on the assets of the security. Preference shares are hybrid securities. The holders of such securities have preference rights over equity shareholders with regard to both a fixed dividend and return of capital.

(ii) Secondary or indirect instruments

Indirect securities are not directly issued by borrowers to lenders. These securities are issued via a financial intermediary to an ultimate lender. Indirect securities include mutual fund units, security receipts, securitized debt instruments.

- Mutual Funds pool the savings of many investors who share a commonfinancial goal. Each scheme of a mutual fund can have different charac-teristics and objectives. Mutual funds issue units to investors, which rep-resent an equitable right in the assets of the mutual fund.
- Security Receipts are bonds issued by Asset Reconstruction Companies to banks when they buy bad loans from them. Normally, when thesecompanies buy bad assets from banks, they do not pay cash up front.They buy stressed assets through security receipts, which are essentiallybonds that can be redeemed later. The bonds (SR) are issued up to maximum period of seven years.
- Securitized debt instruments are products of securitization, which in turn is the process of passing debts on to entities that in turn break them into bonds and sell them. As of 2010, the most common form of securitized debt is mortgage-backed securities, but attempts are being made to securitize other debts, such as credit cards and student loans
- . Securitized debt instruments are created when the original holder (e.g. a bank) sells its debt obligation to a third party, called a Special Purpose Vehicle (SPV).The SPV pays

the original lender the balance of the debt sold, whichgives it greater liquidity. It then goes on to divide the debt into bonds, which are then sold on the open market.

(iii) Derivatives instruments

Derivatives are instruments whose value is derived from the value of one/more basic variables called the underlying asset. They are forwards, futures and options.

- Forward contracts are agreements to exchange an asset, for cash, at a predetermined future date today. At the end of the contract, one can enter into an offsetting transaction by paying the difference in price.
- Future contracts are similar to forward contracts but are highly standardised traceable contracts unlike the latter. They are standardized in terms of size, expiry date and all other features.
- Options establish a contract between two parties concerning the buying or selling of an asset at a reference price. The buyer of the option gains the right, but not the obligation, to engage in some specific transaction on the asset, whereas the seller incurs the obligation to fulfil the transaction if requested by the buyer.

3.Financial Markets

A financial market is one in which financial assets are created or traded. Generally, there is no specific place or location to have/set up a financial market. Wherever a financial transaction takes place, it comes under the purview of the financial market. The financial market has two main components, namely

(i) the Money Market,

(ii) the Capital Market.

(i) Money Market

This is a market for borrowing and lending of short-term funds. It deals in funds and financial instruments that have a maturity period of one day to one year. It is a mechanism through which short-term funds are loaned or borrowed and through which a large part of the financial transactions of a particular country or of the world is carried out. The most important feature of the money market instrument is its liquidity. It is characterized by a high degree of safety of principal. The following are instruments that are traded in the money market:

- **Call and Notice Money Market**: This market functions only for an extremely short period. Here, funds are transacted on an overnight basis. The participants are mostly banks. Therefore, it is also called the Inter-Bank Money Market. In the notice money market, funds are transacted for 2 days and a 14-day period.
- Treasury Bill Market (T-Bills): This market deals in Treasury Bills of a short-term duration issued by the RBI on behalf of the Government of India. At present, three types of treasury bills are issued through auctions, namely, 91-day, 182-day and 364-day treasury bills.
- Certificate of Deposits (CDs): These are issued by Commercial banks and development financial institutions for funds deposited. CDs are unsecured, negotiable promissory notes issued at a discount to the face value. The scheme pertaining to CDs was introduced in 1989 by the RBI, to mainly enable commercial banks to raise funds from the market. At present, the maturity period of CDs ranges from 3 months to 1 year. They are issued in multiples of INR 25 lakhs subject to a minimum of INR 1 crore.

- Commercial Papers (CPs): Commercial Papersare unsecured money market instruments issued in the form of promissory notes or in demat form. These were introduced in January 1990. Commercial Papers can be issued by a listed company that has a working capital of not less thanINR 5 crores. They could be issued in multiples of INR 25 lakhs. The minimum size of issue is INR 1 crore. At present, the maturity period of CPs ranges between 7 days and 1 year. CPs are issued at a discount to its face value and redeemed at its face value.

(ii) Capital Market
This is a market for financial assets, which have a long or indefinite maturity. Generally, it deals with long-term securities that have a maturity period of above one year.

- **Primary Market** This is a market for new issues or new financial claims. Hence, it is also called a New Issue Market. The primary market deals with those securities that are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, the primary market facilitates capital formation. There are three ways by which a company may raise capital in a primary market: (i) Public issue, (ii) Right issue and (iii) Private placement.
- **Secondary Market** The market in which securities are traded after they are initially offered in the primary market is known as secondary market. Generally securities that have already been issued in the primary market are quoted in the stock exchange to provide a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognized by the Government.

(iii) Foreign Exchange Market
The market in which participants are able to buy, sell, exchange and speculate on currencies is the foreign exchange market. Foreign exchange markets are made up of banks, commercial companies, central banks, investment management firms, hedge funds, and retail forex brokers and investors. The forex market is considered to be the largest financial market in the world.

4. Financial Services

The development of a sophisticated and matured financial system in the country, especially after the early 1990s, led to the emergence of a new sector. This new sector is known as the financial services sector. Its objective is to intermediate and facilitate financial transactions of individuals and institutional investors. There are different types of financial services provided in financial markets. The financial service industry can be classified into two broad categories as Fee-based and Fund-based financial services.

(i)Fee-based Financial Services
These services are provided by financial institutions/NBFCs to earn income by way of fee, dividend, commission, discount and brokerage. The major fee-based financial services are as follows:

- Issue management and merchant banking
- Corporate advisory services
- Asset securitization
- Credit rating

(ii) Fund-based Financial Services
In fund-based services, the financial service firm raises funds through equity, debt and deposits and invests the same in securities or lends this out to those who are in need of capital. The major fund-based services are as follows:

- Leasing and hire purchase
- Venture capital
- Factoring and forfeiting

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