INDIAN FINANCIAL SYSTEM

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INTRODUCTION

- Growth of an economy depends upon the proportion of savings and investments i.e. the capital formation.
- The three important and inseparable components of capital formation are :
  - Savings
  - Finance
  - Investments
- Financial system plays a pivotal role in capital formation and hence in economic growth as it serves a link between the savers and investors.
- It comprises a set of components and mechanisms that allows economic transactions to occur.
- It meets the short term and long term requirements of the individual and corporate sector.

INTRODUCTION CONTD….

" Financial systems are crucial to the allocation of resources in a modern economy. They channel household savings to the corporate sector and allocate investment funds among firms"

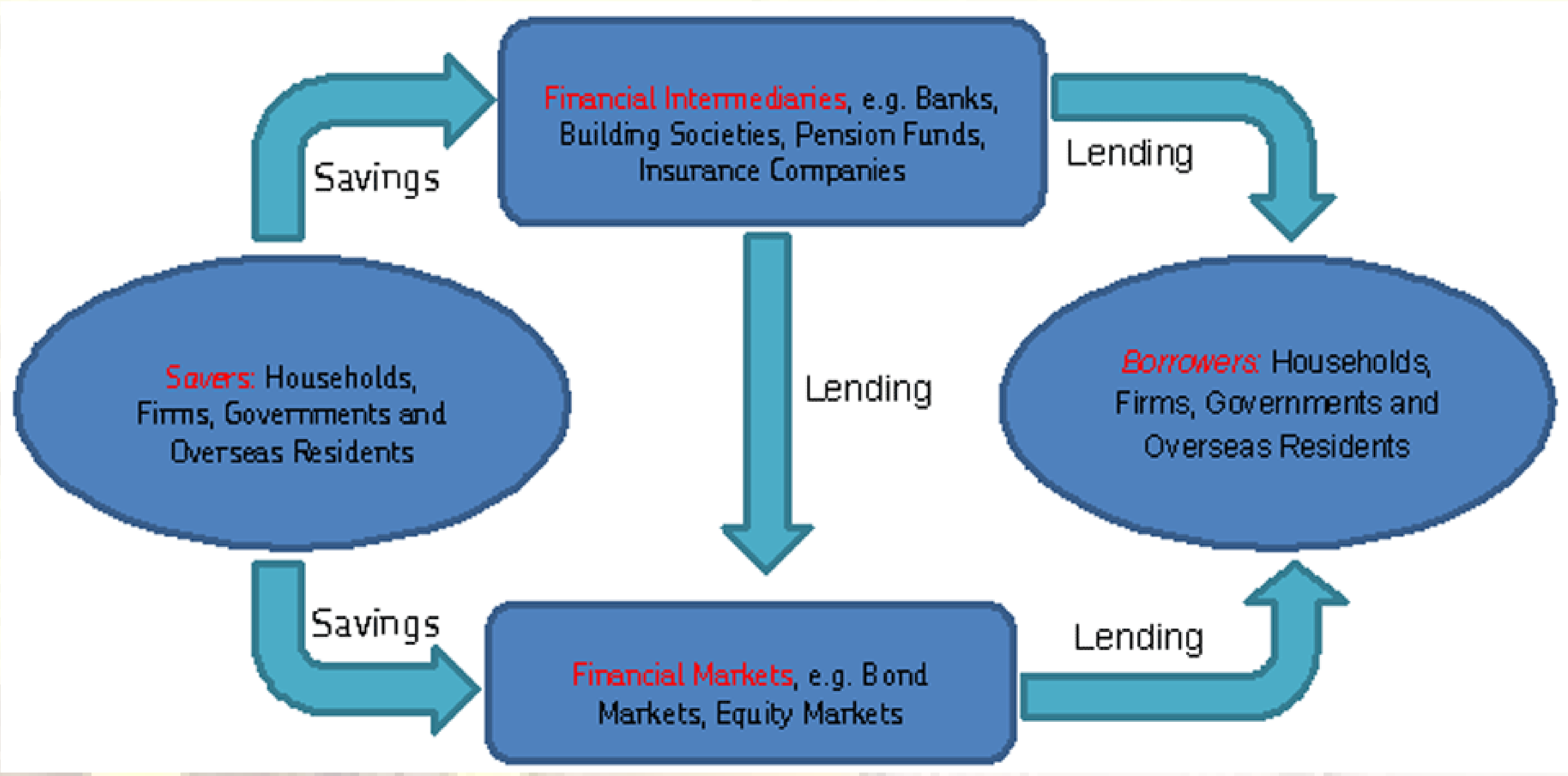
Franklin Allen and Douglas Gale

FINANCIAL SYSTEM = FINANCE + SYSTEM

FINANCE/ FINANCIAL: MONETARY RESOURCES

SYSTEM: SET OF INTERRELATED INSTITUTIONS, MARKETS, DEALERS, AGENTS ETC.

INTRODUCTION CONTD….



FUNCTIONS OF FINANCIAL SYSTEM

Saving Function

- Provides opportunities to invest the savings.
- Link between savers and investors.

Liquidity Function

- Enables the investors to convert their financial assets into liquid form.
- Ensures availability of funds to the investors.

Risk Management Function

- Availability of different options such as hedging, diversification, insurance etc.
- Provides safe modes of investment

Capital Formation

- Fills the gap between the supply of and demand for investible funds.

FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

- Saving investment relationship
- Promotes the growth of capital market
- Growth of infrastructure
- Development of trade
- Capital formation
- Economic stability

COMPONENTS OF INDIAN FINANCIAL SYSTEM

- Financial system comprises the institutional framework that facilitates the transactions of financial nature.
- Main constituents/ components of Indian financial system are:
  - Financial Institutions
  - Financial Markets
  - Financial Instruments
  - Financial Services

COMPONENTS CONTD…..

(I) Financial Institutions

- Institutions which deal in lending and borrowing of funds.
- Types of financial institutions are:
  - Banking Institutions
  - Non Banking Financial Institutions

(A)Banking Institutions: An institution that accepts deposit, give loans and provide other services.

STRUCTURE OF INDIAN BANKING SYSTEM

- Commercial Banks
- Co-operative Banks
- Development banks

FINANCIAL INSTITUTIONS CONTD….

(i) Commercial Banks:

- An institution that accepts demand deposits and makes commercial loans and is regulated by the regulatory agency.
- Can be scheduled commercial banks or non scheduled commercial banks
- Scheduled commercial banks are included in the second schedule of Reserve Bank of India and must fulfill following conditions:
  - Must be carrying on the business of banking
  - Can be a public sector bank, private sector bank, foreign bank or a cooperative bank.
  - Must ensure RBI that its operations are not detrimental to the interest of depositor.
  - Must be a corporation or co-operative society and not asingle owner or partnership firm.

FINANCIAL INSTITUTIONS CONTD….

(ii) Co-operative Banks

- A financial entity created by its members who are owners as well as customers of the bank.
- Regulated by Reserve Bank of India, Banking Regulation Act, 1949 and co-operative Societies act, 1965.
- Mainly concerned with agricultural and rural sector
- Works for the welfare of the society
- Three tier body operating at district, state and central level

FINANCIAL INSTITUTIONS CONTD….

3. Development Banks

- Financial institutions which provide medium and long term finance.
- Mainly concerned with the economic development of the country.
- Provides refinance facility.
- Subscribes or underwrites the securities.
- Some of the major development banks in India are:
    - Industrial development bank of India (IDBI)
    - Industrial Finance Corporation of India (IFCI)
    - Export- Import Bank of India (EXIM Bank)
    - National Bank for Agriculture and Rural Development (NABRAD)

FINANCIAL INSTITUTIONS CONTD….

(B) Non Banking Financial Institutions

- Supplements the role of banking in meeting the financial needs of different sectors of the economy.
- Regulated either by RBI or the concerned regulatory authority.
- Main types of Non Banking Financial Institutions are:
  - Asset Finance Company: Carries on the principle business of financing of physical assets.
  - Investment Company: Principal business is acquisition of shares.
  - Loan Company: Concerned with providing of loans.
  - Infrastructure Finance Company : Mainly provides loans for infrastructure projects.
  - Factors: Engaged in the business of factoring.

DIFFERENCE BETWEEN BANKING AND NON BANKING FINANCIAL INSTITUTIONS

Basis	Banking Institutions	Non Banking Financial Institutions
Public Deposits	Accept the public deposits	Cannot accept public deposits
Nature	Homogeneous in nature	Heterogeneous in nature
Scope	Wide	Narrow
Credit Creation	Yes	No
Purpose of Investment	Safety and liquidity	Earn higher returns

COMPONENTS CONTD….

(II) Financial Markets

- Acts as a connecting link between the buyers and sellers of financial instruments
- Need not be a physical place .
- Main types of financial markets are
  - Money Market
  - Capital Market

FINANCIAL MARKETS CONTD….

1. Money Market

- ✓ Deals with short term securities (Maturity period less than one year).
- ✓ Brings equilibrium between demand and supply of short term funds.
- ✓ Enhances liquidity.
- ✓ Consists of several sub markets.
- ✓ Helps in overcoming deficit of short term funds.

FINANCIAL MARKETS CONTD….

2.Capital Market

- Deals with long term securities (maturity period more than one year).
- Pivotal in capital formation.
- Helps in proper allocation of resources.
- Comprises two sub parts i.e. primary market and secondary market
- Primary market is concerned with first time issue of securities and secondary market is concerned with the existing securities.

DIFFERENCE BETWEEN MONEY MARKET AND CAPITAL MARKET

Basis	Money market	Capital Market
Maturity Period	Less than one year	More than one year
Instruments	Call money, acceptances, bills of exchange etc.	Shares, debentures,
Institutions	Central bank, commercial banks, NBFCs	Stock exchange
Risk	Less	High
Role	Liquidity adjustment	Capital formation
Transaction Cost	Less	More

COMPONENTS CONTD….

(III) Financial Instruments

- The instruments which are used for raising the resources.
- Mainly of two types
    - *Capital Market Instruments*- Used for raising money from the capital market. (Preference shares, equity shares, share warrants, debentures and bonds)
    - *Money Market Instruments:* Used for raising money from the money market. (Treasury bills, commercial papers, call loans etc.)

COMPONENTS CONTD….

(IV) Financial Services

- ✓ Concerned with providing finance .
- ✓ Leads to expansion of activities of the financial markets.
- ✓ Leads to economic development.
- ✓ Promotes investment and savings.
- ✓ Promotes domestic and foreign trade.

TYPES OF FINANCIAL SERVICES

Fund Based	Fee Based
Leasing Finance	Issue Management
Hire Purchase	Loan Syndication
Bill Discounting	Capital Restructuring
Venture Capital	Portfolio Management
Housing Finance	Credit Rating
Insurance Services	Corporate Counselling

OVERVIEW OF INDIAN FINANCIAL SYSTEM

- Indian financial system has undergone different stages of development and can be studied on the basis of three main eras as follows:
  - Pre Independence period
  - Post Independence but before 1991
  - After 1990s

OVERVIEW CONTD……

1. Pre- Independence Period

- ✓ Consisted of the unorganised sector comprising the indigenous bankers.
- ✓ Main thrust was on agriculture rather than industry.
- ✓ No regulatory authority.
- ✓ Limited access to outside resources.

OVERVIEW CONTD……

2. Post- Independence but before 1991

(A) Nationalisation of Private Sector

- Nationalisation of RBI in 1948.
- Establishment of State bank of India and its subsidiaries (1955).
- Nationalisation of 14 banks in 1969.
- Nationalisation of 6 banks in 1980.
- Life Insurance corporation was established (!956)
- General Insurance Corporation was establishe in 1972.

OVERVIEW CONTD……

(B) Strengthening of Financial Institutions

A number of financial institutions were established to strengthen the financial system

Year	instit0utions	Purpose
1948	Industrial finance Corporation of India (IFCI)	To finance the industrial sector
1955	The Industrial Credit and Investment Corporation of India Ltd.	To support other financial institutions
1964	Industrial Development Bank of India	Established as an apex development bank
1964	Unit Trust of India (UTI)	To provide various investing opportunities

OVERVIEW CONTD……

3. After 1990s

- New economic policy 1991 was introduced on the recommendation of Narsimham committee focusing mainly on Liberalisation, Privatisation and Globalisation.
- Deregulation of interest rate.
- Reduction in SLR and CRR
- Setting up of CRISIL
- Establishment of Insurance Regulatory and Development Authority (IRDA)
- Foreign Institutional Investment (FII), banks and private sector allowed to enter the mutual fund market.

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