B.V.V.Sangha’s
Shri S.R.Kanthi Arts ,Commerce & Sccience College Mudhol
Prof. S M Khot

INDIAN FINANCIAL INSTITUTIONS AND MARKETS
MODULE 1

STRUCTURE OF INDIAN FINANCIAL SYSTEM

Introduction: The economic development of any Country depends upon the existence of a well-organized financial system. When the system functions properly, it channelizes funds from savers to investors. The term financial system is a set of interrelated activities or services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, capital formation and growth. In simple words, financial system refers to all the securities, intermediaries and markets that exist to make transfers from savers to borrowers possible.

Definition: A set of complex and closely interconnected financial institutions, markets, instruments, services, practices and transactions through which financial surpluses available in the economy are mobilized.

Features/Characteristics/Role of Financial System:

1. It plays a vital role in the economic development of a country.
2. It encourages both savings and investments.
3. It helps in lowering the transaction costs and increase returns. This will motivate people to save more.
4. It links both savers and investors.
5. It helps in mobilizing and allocating the savings efficiently and effectively.
6. It plays a crucial role in economic development through saving-investment process. This savingsinvestment process is called capital formation. So, financial system helps in capital formation.
7. It helps in bringing investments.
8. It facilitates expansion of financial markets.
9. It helps in allocation of funds.
10. It is a set of inter-related activities or services.
11. It creates a bridge between investors and companies.
12. It helps in fiscal discipline and control of the economy.
13. It brings accountability for investors.
14. It helps to monitor corporate performance.
15. It provides a mechanism for managing uncertainty and controlling risk.
16. It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.

Objectives of Financial System:

The primary objectives of a financial system are concerned to formulate capital, facilitate investment and profit generation. The major and primary objectives of a financial system are as follows:

1. To mobilize the Savings: The financial system begins its operations by the mobilizing of savings from the small saving community. It collects the funds by offering different schemes which attract the investors' i.e., savers to fund their savings in different institutions, services, securities etc.

2. To distribute the savings for the industrial investment: The purpose of mobilizing the fund from the saving community is to invest them in different industries. Thereby it meets the fund requirement of industrial sector. Hence it helps in the growth of industrial sector.

3. To stimulate capital formation: The objective of supporting the industries is not ended with sanctioning of fund to them. Further, it makes them to formulate the capital out of their earnings for the further capital requirement and industrial investment.

4. To accelerate the pace of economic growth: The ultimate aim of the financial institutions is to support the process of economic growth of a nation. Directing the saving fund to the industrial capital need, motivating them for capital formation support the acceleration of the process of economic growth.

Functions of Financial System:

The following are the functions performed by the financial system of a nation. These are the aggregate functions performed by the sub classes of financial system viz. financial markets, financial institutions and financial services.

1. Provision of Liquidity: The provision of liquidity is one of the primary functions of financial system. It states the ability of meeting the obligations as and when they are required. In other words, it states the ability of converting the assets into liquid cash without any loss.

2. Mobilization of savings: Savings are done by millions of people. But amount saved are of no use unless they are mobilized into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, mutual funds bonds or equity shares. It is the function of financial institutions, a subdivision of financial system to mobilize the savings from the saver or investment group.

3. Small Savings to big investment: Financial system acts as an intermediary in transforming the mobilized fund of savings to the big investments. It channelizes small savings fund received from the savings group to the industries to investments.

4. Maturity Transformation function: It is also one of the intermediary functions of financial system. The financial institutions receive the saving fund from the depositors for a particular tenure and lend the same fund to the required people on term basis.

5. Risk Transformation function: The financial system also does a function of risk transformation. The small savers are usually risk averse, who doesn't want to invest their small saving fund in the risky ventures. Hence the financial institutions take the responsibility of transforming their risk in investing their funds in profitable and safe venture by bearing the risk.

6. Payment function: The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced. The payment mechanism is now being increasingly made through electronic means.

7. Pooling of funds: A financial system provides a mechanism for pooling of funds to invest in large scale enterprises.

8. Monitor Corporate performance: A financial system not only helps in selecting the projects to be funded but also motivates the various stakeholders of the financial system to monitor the performance of the investment.

9. Provide price related information: Financial markets provide information which enables the investors to make an informed decision about whether to buy, sell or hold a financial asset. This information dissemination facilitates valuation of financial assets.

10. Information function: Financial markets disseminate information for enabling participants to develop informed opinion about investment, disinvestment, reinvestment or holding a particular asset.

11. Transfer function: A financial system provides a mechanism for the transfer of resources across geographic boundaries.

12. Reformatory function: A financial system, undertakes the functions of developing, introducing innovative financial assets/instruments. Services and practices and restructuring the existing assets, services etc., to cater to the emerging needs of borrowers and investors. I.e. financial engineering and reengineering.

Types of financial system:

The Indian financial system can be broadly classified into two types i.e.

1. Formal (organized) financial system: This is also known as organized financial system because it comes under the purview of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI), and regulatory bodies. Formal financial system consists of four sub-systems.

These are: • Financial Institutions • Financial Markets • Financial Instruments • Financial Services

2. Informal (unorganized) financial system: The informal financial system consists of individual money lenders, groups of persons operating as associations, partnership firms consisting of local brokers' pawn brokers and non-banking financial intermediaries such as finance, investment and chit fund companies. These people have a system and they have their own rules on how they should function in their day-to-day activities. However, the formal financial system is always preferable because it is systematic, transparent and offers numerous benefits.

FINANCIAL INSTITUTIONS:

Meaning: Financial Institutions are business organizations serving as a link between savers and investors and so help in the credit allocation process. In simple words, Financial Institutions are the institutions which offer financial services for its clients or members. The most probable service is financial intermediation. The institutions include banks, trust, companies, insurance companies and investment dealers. In other words, the financial institution is an organization which may be either profit or non-profit, that takes money from clients and places it in any of a variety of investment vehicles for the benefit of both the client and the organization.

Salient feature of Financial Institutions:

1. It is an institution as well as intermediary.
2. It channelizes savings fund into investment fund.
3. It creates financial assets such as deposits, loans, securities etc.
4. It includes banking and non-banking institutions.
5. It includes both organized and unorganized institutions.
6. Established with a clear operating function. Regulated by the government and regulating authority.
7. It accepts deposits. It provides commercial loans, real estate loans and mortgage loans.
8. Financial institutions keep money flowing through the economy among consumers, businesses and government.

Classification of Financial Institutions:

These are also to be classified into banking and non-banking institutions.

Banking Institutions: These are the type of financial institutions which involve in accepting public deposits and lending the same to the needy customers. These are fundamentally established to earn profit, secondarily to safeguard the interest of the members. The banking institutions ensure that deposits accumulated from people are productively utilized. The following are the types of banking institutions which are running their business in India.

A) Scheduled Banks are banks included in 2nd Schedule of RBI Act, 1934. It is mandatory that they adhere to RBI guidelines and maintain a cash reserve with the RBI on a daily basis. The total paid up capital and reserve must be of Rs. 5 lacs or more. Scheduled banks are further classified as commercial banks and co-operative banks.

I)Commercial banks: Commercial Bank offers banking services to individuals and businesses. These are regulated by Banking regulation Act 1949. Borrowers are account holders. Following are the types ofcommercial banks.

i. Public sector:In this the Government holds more than 51% of the share capital of a publicly listed banking company. Ex.: SBI and its associates, Canara Bank, Bank of Baroda etc.

ii. Private sector: When private individuals own more than 51% of the share capital, then that banking company is a private one. However, these banks are publicly listed companies in a recognized exchange.Ex.: ICICI Bank, HDFC Bank, Axis Bank, Yes Bank.

iii. Regional Rural Banks (RRB`s): These banks that conduct banking activities for rural areas at state level. Main aim is financial inclusion of small and medium farmers, agricultural labourers and small artisans etc., The equity of the Regional Rural Banks is held by the stakeholders in a fixed proportion. This proportion is 50:35:15, distributed as: Central Government – 50%, Sponsor Bank – 35%, State Government – 15%. Ex: Karnataka Grameena Vikas Bank (Sponsored by Canara Bank)

iv. Foreign banks: Banks set up in foreign countries, and operate their branches in the home country are called as foreign banksEx: HSBC Bank, Deutsche Bank, Standard Chartered Bank etc.

II)Co-operative Banks: A Co-operative bank is established to safeguard the interest of its members (shareholders). These are organized on a co-operative basis, accept deposits and lend money to the required members.These are regulated by Co-operative Societies Act 1965. Borrowers are members/ shareholders. These are further classified as State Cooperative Bank (Karnataka State Co-operative Apex Bank), District Co-operative Bank (The Belgaum District Central Co-operative Bank) and Other Co-operative Banks (Land development Banks, Fishermen Co-op. Bank etc), Cosmos Co-operative Bank, Maratha Cooperative Bank, Shree Basaveshwar Co-operative Bank etc.

B) Non-scheduled Banks are banks which are not included in 2nd Schedule of RBI Act, 1934. It is also not mandatory that they adhere to RBI guidelines and no need to maintain a cash reserve with the RBI on a daily basis. The total value of paid up capital and reserve can be of less than Rs. 5 lacs.Ex: Karur Vysya Bank, Laxmi Vilas Bank, Ratnakar Bank etc

Non-banking Institutions: These are the financial institutions that provide banking services without meeting the legal definition of a bank. Non-banking institutions don’t accept deposits (cash) from the public but offer various financial products and services to their customers.Following are examples of non-banking institutions:

i. Provident and pension fund. ii. Small Saving organization. iii. Life Insurance Corporation (LIC). iv. General Insurance Corporation (GIC). v. Unit Trust of India (UTI). vi. Mutual funds. vii. Investment Trust, etc.

Importance of Financial Institutions:

Provide funds: Financial institutions provide funds for the investment and industrial activities. Infrastructural facilities: Financial institutions also offer basic infrastructural facilities needed for the development and promotion of lucrative ventures. Infrastructural facilities involve development of industrial estates tech parks, road and water etc.

Promotional activities: Promotional activities are undertaken by the financial institutions to mobilize the funds, reduce the risk of selling financial securities, arrangement of working and long term capital of the business.

Development of backward areas: Apart from the financial activities, financial institutions also take some social responsibilities of developing the backward areas at free of cost by offering credit facilities, free education, employment creation etc.

Planned development: Financial institutions initiate all planned developments in the view of economic growth of the state. All planned developments are coordinated with the government plan and social welfare.

Accelerating industrialization: Since the financial institutions are established to earn the profit and safeguard interest of its members, they accelerate the industrialization to contribute industrial growth. They support industries by granting finance, project development and consultancy.

Employment generation: channelizing the funds for investment, building of infrastructural facilities, and acceleration of industries generates employment to the educated and qualified people of the state.

Functions of Financial Institutions:

The functions of financial institutions are classified into primary functions and secondary functions. Primary functions: These are the basic functions of financial institutions which come in the respective group of institutions like banks, co-operative societies, insurance industries etc. the primary functions are as follows:

Accepting deposits: Most of the financial institutions viz, commercial banks, cooperative societies etc., accept deposits from the public. They offer different schemes to mobilize public deposits from the customers. For the accepted deposits, financial institutions give return in the form of interest on deposit tenure basis.

Providing commercial loans: Accepted deposits are used for commercial lending operations in the form of loans, advances, cash credits, bill discounting etc., these fetch good return to the financial institutions.

Providing Real estate loans: The financial institutions also provide loans and advances for real estate industries to purchase sit, build premises, construction of industrial and residential parks.

Providing mortgage loans: The financial institutions also provide loans to the needy group on mortgage of properties and collateral securities. For example, Gold loan, property loan etc. where gold and properties are mortgaged to avail the loan.

Issuing share certificates: Financial institutions also undertake the job of issuing share certificates of any established corporate to its shareholders. It also constitutes accepting shares investment money from the investors and issuing them certificates on behalf of the companies.

Secondary Functions: these are the additional functions performed by the financial institutions along with the above primary functions. Secondary functions are as follow:

Act as an intermediary: financial institutions act as an intermediary in between the savings community and industrialist. They receive the public deposit at a lower rate of interest and lend the same fund to the needy group at higher rate of interest. The difference amount of interest is the profit for their intermediary work.

Facilitate the flow of money: they also facilitate the flow/channelize the money to the investment activities. Financial institutions are the interlinked path stones to make smooth flow o fund from small savers to giant business ventures.

FINANCIAL MARKETS:

Financial markets refer to any marketplace where buyers and sellers participate in trading of assets such as shares, bonds, currencies, and other financial instruments. It can be an actual physical place like the stock exchange or just a virtual one (online transaction). Hence, we can say that whenever a financial transaction takes place, it occurs in the financial market. A financial market may be further divided into capital market and money market. The capital market deals in long term securities having maturity period of more than one year. The money market deals with short term debt instruments having maturity period of less than one year.

Importance of financial markets

Financial markets are the essential players in the economic development of a nation. They function as facilitating originations in the savings-investment process and act as an effective part of a financial system.

Financial markets facilitate easy and quick liquidity of funds. Due to advancement in internet and technology.

financial markets through demat/online accounts ensure speedy conversion of assets (securities) into cash and vice versa.

The individuals, financial institutions, corporations and government trade in this market either directly or indirectly through brokers and dealers.

CLASSIFICATION OF FINANCIAL MARKETS:

The financial markets in India are classified into two broad categories, viz. unorganized markets and organized markets.

UNORGANIZED FINANCIAL MAREKTS: These are comprised with private money lenders, pawn brokers, indigenous bankers, traders etc. they lend money to the public from their own funds. The operations and activities of these people are not regulated by the Reserve Bank of India or by any other controlling authority.

ORGANIZED FINANCIAL MARKETS: These are the markets strictly controlled and regulated by Reserve Bank of India or any other regulating authorities. They follow high degree of institutionalization and instrumentalization. The organized financial markets are further classified into capital market and money market.

A) CAPITAL MARKET: Capital market is a market for financial assets which have a long or indefinite maturity. The capital market instruments mature for the period above one year. It is also called as long-term securities market. It is an institutional arrangement to borrow and lend money for a longer period of time.

It consists of financial institutions like IDBI, ICICI, UTI, LIC etc.These institutions play the role of lenders in the capital market. Business units and corporates are the borrowers in the capital market.

B) MONEY MARKET: Money market is a market where money or its equivalent can be traded. It does not actually deal in cash or money. It deals with near money substitutes like trade bills, promissory notes and government papers drawn for a short period not exceeding one year. The very feature of these instruments is they can be converted into cash readily without any loss and at low transaction cost.

This market consists of financial institutions and dealers in money or credit who wish to generate liquidity. Hence, money market is a market where short-term obligations such as treasury bills, commercial papers and bankers acceptances are bought and sold.

FINANCIAL INSTRUMENTS/ASSETS:

Financial assets/ instruments are defined as "an asset that derives value because of contractual claim." The contractual claim is the repayment of principal at a pre-determined date, with the agreed rate of return (interest/ dividend) if any.

In any financial transaction, these should be a creation or transfer of financial asset. Hence, the basic product of any financial system is the financial asset. A financial asset is one which is used for production or consumption or for further creation of assets.

One must know the distinction between financial assets and physical assets. Physical assets are not useful for further production of goods or for earning incomes. For instance, if a building is bought for residential purpose, it becomes a physical asset. If the same is bought for renting it out, it becomes a financial asset. Financial instruments are also called as financial assets/securities.

CHARACTERISTICS OF FINANCIAL INSTRUMENTS:

Liquidity: Financial instruments provide liquidity. These can be easily and quickly converted into cash. Marketing: Financial instruments facilitate easy trading on the market. They have a ready market. Collateral value: Financial instruments can be pledged for getting loans.

Transferability: Financial instruments can be transferred from one person to another.

Maturity period: The maturity period of financial instruments may be short term, medium term or long term.

Transaction cost: Financial instruments involve buying and selling cost. The buying and selling costs are called transaction costs.

Risk: Financial instruments carry risk. Equity based instruments are riskier in comparison to debt based instruments because the payment of dividend is uncertain. A company may not declare dividend in a particular year.

Future trading: Financial instruments facilitate future trading so as to cover risks arising out of price fluctuations, interest rate fluctuations etc.

CLASSIFICATION OF FINANCIAL INSTRUMENTS:

Financial instruments are classified into term financial instruments and type financial instruments.

Term financial instruments:

These are the tradable financial assets and exchanged on term basis.

These are again classified into short term, medium term and long term securities.

Short term securities: This sub category comprises securities with maturity of one year or less.

Medium term securities: Basis for classifying securities under this sub category depends on practices applied in financial markets of the given Country. Normally, this sub-category includes securities with maturity from 1 to 5 years.

Long term securities: This sub-category comprises securities with maturity longer than those of short and medium term securities.

Type based securities: Under this classification financial securities are classified into primary, secondary and innovative securities.

Primary instruments/securities: Primary securities are defined as a financial instrument whose value is not derived from that of another instrument, but instead is determined directly by the market." The examples for the primary instruments are equity shares, preference shares and debentures.

Secondary instruments/securities: Secondary securities are defined as a financial instrument whose value is derived from that of another instrument For example, when you are investing in a mutual fund, you are investing in a secondary security because the value i.e., the NAV (Net Asset Value) of the Mutual fund depends on the performance of the securities that the mutual fund invests in.

Innovative instruments: These are the financial innovative instruments to suit the need of investors groups. For example, Derivatives, foreign currency mortgages and so on.

FINANCIAL SERVICES:

Financial service refers to services which are financial in nature offered by a financial business to its customers. Its objective is to intermediate and facilitate financial transactions of individuals and institutional investors. Financial Service is concerned with the design and delivery of financial instruments, advisory services to individuals and businesses in the area of banking and related institutions, personal financial planning, leasing, investment, assets, insurance etc.

IMPORTANT TYPES OF FINANCIAL SERVICES:

There are so many financial services that the financial market offers. The most important ones are as follows:

a) Banking services

b) Foreign Exchange Services: Foreign exchange services are provided by many banks around the world. Foreign exchange services include: Currency Exchange, Wire Transfer, Foreign Currency Banking: The transactions are done in foreign currency.

c) Investment Services: Asset Management, Hedge fund management, Custody Services

d) Insurance Services: Sales of insurance policies, brokerages, insurance underwriting or the reinsurance.

e) Other Financial Services: Advisory services, Venture Capital, Angel Investment etc.

CLASSIFICATION OF FINANCIAL SERVICES:

Financial Services are classified into Fund Based Services and Fee Based Services, which are as follows:

A) Fund Based Services: Fund based or asset based financial services are those services which are rendered for commission basis or for ascertain amount of interest.

Leasing: It refers to a written agreement between lessor and lessee where lessor allows lessee to use his property for specified period of time or rent is called lease.

Factoring: Factoring is a facility provided by factor (financial institution) to its clients (company), whereas factor purchase debts and receivable accounts of the clients at discount rates and offers immediate cash. This facility is called as factoring. It is also called as account receivable finance.

Bills Discounting: Trading or selling bills to financial institution prior to its maturity period for discount rate is called discounting bill of exchange. The rate of discount depends on the time left before the bill mature and risk attached to it.

Venture Capital: Venture capital is a way of financial by investor to companies for its startup and to promote project. Investor joins entrepreneurs as co-promoter and share risk and returns

Loan: Loan is an oral or written agreement between lender and borrower for temporary transfer of property (cash) from lender to borrower where borrower promises to return the same property for cash along with pre-determined interest as per the agreement.

Housing Finance: Housing finance is a finance facility provided by housing finance company on acquisition or construction of houses, which includes acquisition or development of land in connection therewith.

Hire Purchase: Hire purchase system is a method of selling goods on credit where purchaser is allowed to purchase goods and allow him to pay the amount in installment basis and the title of the goods transferred from seller to buyer at the end of financial installment.

B) Fee Based Services: Fee based financial services are those which are paid for a flat fee rather than commission. Those services are known as fees based services are as follows:

Portfolio management: portfolio management is a method of managing and allocating funds on various known as portfolio alternatives to reduce the uncertainty is known as portfolio management.

Loan Syndication: loan syndication is the process where large number of lenders contributes amount and grant loans to company or any project and share risk and returns of the same.

Corporate Counseling: corporate counseling refers to a set of activities performed to ensure the efficient running of a corporate enterprise and to improve the performance.

Foreign Collaboration: foreign collaboration is an alliance in corporate to carry on agreed task collectively with the participation of resident and non-resident entities.