INDIAN FINANCIAL SYSTEM

The economic development of any country depends upon the existence of a well organised financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promote the well-being and standard of living of the people of a country. Thus, the ‘financial system’ is a broader term which brings under its fold the financial markets and the financial institutions which support the system. The responsibility of the financial system is to mobilise the savings in the form of money and monetary assets and invest them to productive ventures. An efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development.

FUNCTIONS OF THE FINANCIAL SYSTEM

1. ***Provision of liquidity***: The major function of the financial system is the provision of money and monetary assets for the production of goods and services. There should not be any shortage of money for productive ventures. The term liquidity refers to cash or money and other assets which can be converted into cash readily without loss of value and time.

2. ***Mobilisation of savings:*** Another important activity of the financial system is to mobilise savings and channelise them into productive activities. The financial system facilitates the transformation of savings into investment and consumption. The financial intermediaries have to play a dominant role in this activity.

3. ***Size transformation function***: Generally, the savings of millions of small investors are in the nature of a small unit of capital which cannot find any fruitful avenue for investment unless it is transformed into a perceptible size of credit unit. Banks and other financial intermediaries perform this size transformation function by collecting deposits from a vast majority of small customers and giving them as loan of a sizeable quantity. Thus, this size transformation function is considered to be one of the very important functions of the financial system.

4. ***Maturity transformation function***: Another function of the financial system is the maturity transformation function. The financial intermediaries accept deposits from public in different maturities according to their liquidity preference and lend them to the borrowers in different maturities according to their need and promote the economic activities of a country.

5. ***Risk transformation function***: Most of the small investors are risk-averse with their small holding of savings. So, they hesitate to invest directly in stock market. On the other hand, the financial intermediaries collect the savings from individual savers and distribute them over different investment units with their high knowledge and expertise. Thus, the risks of individual investors get distributed.

FINANCIAL CONCEPTS

The financial system comprises of the following important concepts: (i) Financial assets. (ii) Financial intermediaries. (iii) Financial markets. (iv) Financial rates of return. (v) Financial instruments.

FINANCIAL ASSETS

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. For instance, A, buys equity shares and these shares are financial assets since they earn income in future.

Unlike financial assets, physical assets are not useful for further production of goods or for earning income. For example, X purchases land and buildings, or gold and silver. These are physical assets since they cannot be used for further production. Many physical assets are useful for consumption only.

It is interesting to note that the objective of investment decides the nature of the asset. For instance, if a building is bought for residence purposes, it becomes a physical asset. If the same is bought for hiring, it becomes a financial asset.

Classification of financial assets

Financial assets can be classified differently under different circumstances. One such classification is: (i) Marketable assets (ii) Non-marketable assets Marketable assets Marketable assets are those which can be easily transferred from one person to another without much hindrance.

Examples: Shares of Listed Companies, Government Securities, Bonds of Public Sector Undertakings, etc. Non-marketable assets On the other hand, if the assets cannot be transferred easily, they come under this category. Examples: Bank Deposits, Provident Funds, Pension Funds, National Savings Certificates, Insurance Policies, etc.

***Cash asset***:

In India, all coins and currency notes are issued by the RBI and the Ministry of Finance, Government of India. Besides, commercial banks can also create money by means of creating credit. When loans are sanctioned, liquid cash is not granted. Instead, an account is opened in the borrower’s name and a deposit is created. It is also a kind of money asset.

***Debt asset***

Debt asset is issued by a variety of organisations for the purpose of raising their debt capital. Debt capital entails a fixed repayment schedule with regard to interest and principal. There are different ways of raising debt capital. Example: issue of debentures, raising of term loans, working capital advance, etc.

***Stock asset***

Stock is issued by business organisations for the purpose of raising their fixed capital. There are two types of stock-namely equity and preference. Equity shareholders are the real owners of the business and they enjoy the fruits of ownership and at the same time they bear the risks as well. Preference shareholders, on the other hand get a fixed rate of dividend.

FINANCIAL INTERMEDIARIES

The term financial intermediary includes all kinds of organisations which intermediate and facilitate financial transactions of both individuals and corporate customers. Thus, it refers to all kinds of financial institutions and investing institutions which facilitate financial transactions in financial markets. They may be in the organised sector or in the unorganised sector. They may also be classified into two: (i) Capital market intermediaries. (ii) Money market intermediaries.

***Capital market intermediaries***

These intermediaries mainly provide long-term funds to individuals and corporate customers. They consist of term lending institutions like financial corporations and investing institutions like LIC.

***Money market intermediaries***

Money market intermediaries supply only short-term funds to individuals and corporate customers. They consist of commercial banks, co-operative banks, etc.

FINANCIAL MARKETS

There is no specific place or location to indicate a financial market. Wherever a financial transaction takes place, it is deemed to have taken place in the financial market. Hence, financial markets are pervasive in nature since, financial transactions are themselves very pervasive throughout the economic system. For instance, issue of equity shares, granting of loan by term lending institutions, deposit of money into a bank, purchase of debentures, sale of shares and so on.

However, financial markets can be referred to as those centres and arrangements which facilitate buying and selling of financial assets, claims and services. Sometimes, we do find the existence of a specific place or location for a financial market as in the case of stock exchange.

Classification of financial markets

***Unorganised markets***

In these markets, there are a number of moneylenders, indigenous bankers, traders, etc., who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds, etc., whose activities are not controlled by the RBI. The regulations concerning their financial dealings are still inadequate and their financial instruments have not been standardised.

***Organised markets***

In the organised markets, there are standardised rules and regulations governing their financial dealings. There is also a high degree of institutionalisation and instrumentalisation. These markets are subject to strict supervision and control by the RBI or other regulatory bodies. These organised markets can be further classified into two. They are: (i) Capital market. (ii) Money market.

***Capital market***

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long-term securities which have a maturity period of above one year. Capital market may be further divided into three namely: (i) Industrial securities market. (ii) Government securities market, and (iii) Long-term loans market.

1. *Industrial securities market*

As the very name implies, it is a market for industrial securities namely: (i) Equity shares or ordinary shares, (ii) Preference shares, and (iii) Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are: (i) Primary market or New issue market. (ii) Secondary market or Stock exchange.

***Primary market***

Primary market is a market for new issues or new financial claims. Hence, it is also called New Issue Market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, primary market facilitates capital formation. There are three ways by which a company may raise capital in a primary market. They are: (i) Public issue. (ii) Rights issue. (iii) Private placement.

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

***Secondary market***

Secondary market is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the Stock Exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognised by the Government of India. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act, 1956.

1. *Government securities market*

It is otherwise called Gilt-edged securities market. It is a market where Government Securities are traded. In India, there are many kinds of Government securities — short-term and long-term. Government Securities are issued in denominations of ` 100. Interest is payable half-yearly and they carry tax exemptions also. The major participant in this market is the ‘commercial banks’ because they hold a very substantial portion of these securities to satisfy their SLR requirements.

1. Long-term loans market

Development banks and commercial banks play a significant role in this market by supplying long-term loans to corporate customers. Long-term loans market may further be classified into: (i) Term loans market. (ii) Mortgages market. (iii) Financial guarantees market.

***Term loans market***

In India, many industrial financing institutions have been created by the Government both at the national and regional levels to supply long-term and medium-term loans to corporate customers directly as well as indirectly. These development banks dominate the industrial finance in India. Institutions like The Financial System in India 13 IRBI, IFCI, and other state financial corporations come under this category. These institutions meet the growing and varied long-term financial requirements of industries by supplying long-term loans. They also help in identifying investment opportunities, encourage new entrepreneurs and support modernisation efforts.

***Mortgages market***

The mortgages market refers to those centres which supply mortgage loan mainly to individual customers. A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage.

***Financial guarantees market***

A guarantee Market is a centre where finance is provided against the guarantee of a reputed person in the financial circle. Guarantee is a contract to discharge the liability of a third party in case of his default. Guarantee acts as a security from the creditor’s point of view. In case the borrower fails to repay the loan, the liability falls on the shoulders of the guarantor. Hence, the guarantor must be known to both the borrower and the lender and he must have the means to discharge his liability. Though there are many types of guarantees, the common forms are: (i) Performance guarantee, and (ii) Financial guarantee. Performance guarantees cover the payment of earnest money, retention money, advance payments, non-completion of contracts, etc. On the other hand, financial guarantees cover only financial contracts.

IMPORTANCE OF CAPITAL MARKET

The importance of capital market can be briefly summarised as follows:

1. The capital market serves as an important source for the productive use of the economy’s savings. It mobilises the savings of the people for further investment and thus, avoids their wastage in unproductive uses.
2. It provides incentives to saving and facilitates capital formation by offering suitable rates of interest as the price of capital.
3. It provides an avenue for investors, particularly the household sector to invest in financial assets which are more productive than physical assets.
4. It facilitates increase in production and productivity in the economy and thus, enhances the economic welfare of the society.
5. The operations of different institutions in the capital market induce economic growth. They give quantitative and qualitative directions to the flow of funds and bring about rational allocation of scarce resources.
6. A healthy capital market consisting of expert intermediaries promotes stability in values of securities representing capital funds.
7. Moreover, it serves as an important source for technological upgradation in the industrial sector by utilising the funds invested by the public.

Thus, a capital market serves as an important link between those who save and those who aspire to invest their savings.

MONEY MARKET

Money market is a market for dealing with financial assets and securities which have a maturity period of up to one year. In other words, it is a market for purely short-term funds. The money market may be subdivided into four. They are: (i) Call money market. (ii) Commercial bills market. (iii) Treasury bills market. (iv) Short-term loan market.

***Call money market***

The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on demand at the option of either the lender or the borrower. The special feature of this market is that the interest rate varies from day-to-day and even from hour-to-hour and centre-to-centre. It is very sensitive to changes in demand and supply of call loans.

***Commercial bills market***

It is a market for bills of exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill, promising to pay at a later date the amount specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill. The growth of the bill market is slow in India. There are no specialised agencies for discounting bills. The commercial banks play a significant role in this market.

***Treasury bills market***

It is a market for treasury bills which have ‘short-term’ maturity. A treasury bill is a promissory note or a finance bill issued by the Government. It is highly liquid because its repayment is guaranteed by the Government. It is an important instrument for short-term borrowing of the Government. There are two types of treasury bills namely: (i) Ordinary or Regular and (ii) ad hoc treasury bills popularly known as ‘ad hocs’.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short-term financial needs. Ad hoc treasury bills are issued in favour of the RBI only. They are not sold through tender or auction. They can be purchased by the RBI only.

Treasury bills have a maturity period of 91 days or 182 days or 364 days only. Financial intermediaries

***Short-term loan market***

It is a market where short-term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market. Commercial banks provide short-term loans in the form of cash credit and overdraft. Overdraft facility is mainly given to business people, whereas cash credit is given to industrialists. Overdraft is purely a temporary accommodation and it is given in the current account itself. But, cash credit is for a period of one year.

FOREIGN EXCHANGE MARKET

he market where foreign exchange transactions take place is called a foreign exchange market. It does not refer to a marketplace in the physical sense of the term. In fact, it consists of a number of dealers, banks and brokers engaged in the business of buying and selling foreign exchange. It also includes the central bank of each country and the treasury authorities who enter into this market as controlling authorities.

FINANCIAL RATES OF RETURN

Most households in India still prefer to invest on physical assets like land, buildings, gold, silver, etc. investment in financial assets like equities in capital market fetches more return than investments on gold. Generally, the interest rate policy of the Government is designed to achieve the following: (i) To enable the Government to borrow comparatively at cheaper rate. (ii) To ensure stability in the macroeconomic system. (iii) To support certain sectors through preferential lending rates. (iv) To mobilise substantial savings in the economy

FINANCIAL INSTRUMENTS

Financial instruments refer to those documents which represent financial claims on assets. Financial asset refers to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend. Examples: Bill of Exchange, Promissory Note, Treasury Bill, Government Bond, Deposit Receipt, Share, Debenture, etc. Financial instruments can also be called financial securities. Financial securities can be classified into: (i) Primary or direct securities. (ii) Secondary or indirect securities.

***Primary securities***.

These are securities directly issued by the ultimate investors to the ultimate savers, e.g., shares and debentures issued directly to the public. Secondary securities These are securities issued by some intermediaries called financial intermediaries to the ultimate savers, e.g., Unit Trust of India and Mutual Funds issue securities in the form of units to the public and the money pooled is invested in companies. Again these securities may be classified on the basis of duration as follows: (i) Short-term securities. (ii) Medium-term securities. (iii) Long-term securities.

Short-term securities are those which mature within a period of one year, e.g., Bill of Exchange, Treasury Bill, etc.

Medium-term securities are those which have a maturity period ranging between one to five years, e.g., Debentures maturing within a period of five years.

Long-term securities are those which have a maturity period of more than five years, e.g., Government Bonds maturing after ten years.

Characteristic features of financial instruments:

Financial instruments possess the following characteristic features:

1. Most of the instruments can be easily transferred from one hand to another without many cumbersome formalities.
2. They have a ready market, i.e., they can be bought and sold frequently and thus, trading in these securities is made possible.
3. They possess liquidity, i.e., some instruments can be converted into cash readily. For instance, a bill of exchange can be converted into cash readily by means of discounting and rediscounting.
4. Most of the securities possess security value, i.e., they can be given as security for the purpose of raising loans.
5. Some securities enjoy tax status, i.e., investments in these securities are exempted from Income Tax, Wealth Tax, etc., subject to certain limits, e.g., Public Sector Tax Free Bonds, Magnum Tax Saving Certificates.
6. They carry risk in the sense that there is uncertainty with regard to payment of principal or interest or dividend as the case may be.
7. These instruments facilitate futures trading so as to cover risks due to price fluctuations, interest rate fluctuations, etc.
8. These instruments involve less handling costs since expenses involved in buying and selling these securities are generally much less.
9. The return on these instruments is directly in proportion to the risk undertaken.
10. These instruments may be short-term or medium-term or long-term depending upon the maturity period of these instruments.

FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

The financial system plays a significant role in the process of economic development of a country. The financial system comprises of a network of commercial banks. Non-banking companies, development banks and other financial and investment institutions offer a varieties of financial products and services to suit to the varied requirements of different categories of people. they play a crucial role in spurring economic growth in the following ways:

1. **Mobilising savings**: The financial system mobilises the savings of the people by offering appropriate incentives and by deepening and widening the financial structure. In other words, the financial system creates varieties of forms of savings so that savings can take place according to the varying asset preferences of different classes of savers. In the absence of the financial system, all savings would remain idle in the hands of the savers and they would not have flown into productive ventures.
2. **Promoting investments**: For the economic growth of any nation, investment is absolutely essential. This investment has to flow from the financial system. In fact, the level of investment determines the increase in output of goods and services and incomes in the country. The financial system collects the savings and channels them into investment which contributes positively towards economic development.
3. **Encouraging investment in financial assets**: The dynamic role of the financial system in the economic development is that it encourages savings to flow into financial assets (money and monetary assets) as against physical assets (land, gold and other goods and services). The larger the proportion of the financial assets, the greater is the scope for economic growth in the long run.
4. **Allocating savings on the basis of national priorities**: Above all, the financial system allocates the savings in a more efficient manner so that the scarce capital may be more efficiently utilised among the various alternative investments. In other words, it gives preference to certain sectors, from the social and economic point of view, on the basis of national priorities.
5. **Creating credit**: Large financial resources are needed for the economic development of a nation. These resources are supplied by the financial system. Thus, it accelerates economic growth by facilitating the transactions of trade, production and distribution on a large-scale.
6. **Providing a spectrum of financial assets**: The financial system provides a spectrum of financial assets so as to meet the varied requirements and preferences of households. Thus, it enables them to choose their asset portfolios in such a way as to achieve a preferred mix of return, liquidity and risk. Thus, it contributes to the economic development of a country.
7. **Financing trade, industry and agriculture**: All the financial institutions operating in a financial system take all efforts to ensure that no worthwhile project – be it in trade or agriculture or industry – suffers due to lack of funds. Thus, they promote industrial and agricultural development which have a greater say on the economic development of a country.
8. **Encouraging entrepreneurial talents**: The financial institutions encourage the managerial and entrepreneurial talents in the economy by promoting the spirit of enterprise and risk-taking capacity. They also furnish the necessary technical consultancy services to the entrepreneurs so that they may succeed in their innovative ventures.
9. **Providing financial services**: Sophistication and innovations have started appearing in the arena of financial intermediations as well. The financial institutions play a very dynamic role in the economic development of a country not only as a provider of finance, but also as a departmental store of finance by offering varieties of innovative financial products and services to meet the ever-increasing demands of their clients both corporates and individuals.
10. **Developing backward areas**: The integral policy of the national development plans of every country concentrates on the development of relatively less developed areas called backward areas. The financial institutions provide a package of services, infrastructure and incentives conducive to a healthy growth of industries in such backward areas and thus, they contribute for the uniform development of all regions in a country.

WEAKNESSES OF INDIAN FINANCIAL SYSTEM

1. *Lack of coordination between different financial institutions*: There are a large number of financial intermediaries. As there is multiplicity of institutions in the Indian financial system, there is lack of coordination in the working of these institutions.
2. *Monopolistic market structures:* In India, some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance, a major share of life insurance business is in the hands of LIC. The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement or lack of effort in mobilising savings of the public and so on. Ultimately, it would retard the development of the financial system of the country itself.
3. *Dominance of development banks in industrial financing*: The industrial financing today in India is largely through the financial institutions created by the Government both at the national and regional levels. These development banks act as distributive agencies only, since, they derive most of their funds from their sponsors. As such, they fail to mobilise the savings of the public. This would be a serious bottleneck which stands in the way of the growth of an efficient financial system in the country.
4. *Inactive and erratic capital market*: The important function of any capital market is to promote economic development through mobilisation of savings and their distribution to productive ventures. Corporate customers don’t resort to capital market since it is very erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets. The weakness of the capital market is a serious problem in our financial system.
5. *Imprudent financial practice*: The dominance of development banks has developed imprudent financial practice among corporate customers. The development banks provide most of the funds in the form of term loans. So, there is a preponderance of debt in the financial structure of corporate enterprises.