CHAPTER - 1

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1.1 FINANCIAL SYSTEM - THE THEORETICAL FRAMEWORK:

Economic development of a country depends on the effective functioning of financial system. Sound financial system is the pre-requisite for the progress of any type of economy. It may be capitalistic, socialistic or mixed economy. Further, financial system is also a key factor influencing the social, political and cultural systems.

Financial system is the mechanism, through which funds are mobilised from surplus units and transferred to deficit units. It encourages the savings, capital formation and facilitates for the smooth credit formation. Financial system primarily comprises of three components, viz., Financial Markets, Financial Instruments and Financial Intermediaries.

Financial Markets:

A market is a place where buyers and sellers meet and function. The price of a commodity is determined primarily on the basis of demand and supply factors.
Financial markets consist of lenders and borrowers. Lenders are the persons who are having surplus funds, borrowers are the persons who are short of funds, the rate of interest is decided basically on demand and supply factors in a market economy. In a developing economy the heavy demand for funds will be always there.

For the purpose of better understanding the financial markets can be broadly classified into two groups.

a) Money Market:

It is the market which supplies short term funds, to fulfill the working capital requirements of industrial and agricultural sectors. The credit which is available in this market is repayable within one year.

b) Capital Market:

It is the market which supplies long term funds, for the capital budgeting requirements of industrial and agricultural sectors. The credit which is available in this market is repayable after one year. Most of the industrial units depend on the primary market to raise the funds through Public Issues. Secondary market which provides liquidity to the primary market is known as Stock Market. Stock Market plays a vital role in the capital market.
Table 1.1
Classification of Financial Markets

FINANCIAL MARKETS

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| |------------------------|
| | |------------------------|
| | MONEY MARKETS CAPITAL MARKETS |
| | |------------------------|
| | | |------------------------|
| | | | PRIMARY MARKET SECONDARY MARKET |

In developed countries money market and capital market are segregated, and specialised institutions are developed with highly professional skills to deal with the financial market. In our country financial markets are under-developed so as yet there are no specialised agencies to operate separately in money market and capital market. All the agencies operate in both the markets.

Financial Instruments:

These instruments are used in the financial market by various agencies for the purpose of raising funds. Financial instruments are of two types.
a) Money Market Instruments:

Treasury Bills

These were introduced by Reserve Bank of India (RBI) in November, 1986, initially issued by RBI on a monthly basis followed by auction. The month period was changed to 14 days in July, 1988. These bills can also be rediscounted.

Commercial Bills

These instruments facilitate trade credit. Banks provide discounting facility for these bills.

Certificates of Deposit

Certificates of Deposit are short-term deposit instruments with maturity period running from 3 months to 365 days. These are issued by the companies to fulfill their working capital requirements. The minimum amount of a Certificate of Deposit is Rs 25 lacs.

Commercial Papers

Commercial Papers are unsecured promissory notes floated by highly rated companies with a tangible net worth of Rs 5 crores or more having a maturity period of 3 months to 6 months. The minimum issue amount is Rs 25 lacs.
Call Money, Term Money and Notice Money:

Call money and short notice money are of one day to 14 days duration at the market rate of interest. Banks, Mutual Funds and DFHI participate in such instruments.

b) Capital Market Instruments:

Shares

Share is a part of capital, the person who purchases the shares is a share holder of the company. A share holder is an owner of the company to the tune of his share.

Equity Shares

These are ordinary shares. The equity share holders have a voice in managing the company. The returns which they receive are dividends. There is no guarantee of dividends. The equity share holders once they have invested, can not get back their capital from the company.
Preference Shares

Preference Shareholders have the right to receive a fixed rate of return on their investment. In the case of windingup of the company, they have preference over equity shareholders to get back their capital.

Debentures (Bonds)

Debenture holders are the creditors of the company. They receive a fixed rate of interest per annum and get back their principal amount after certain period.

Convertible Debentures

The holders of these instruments have the option to convert their debentures into shares after some time.

Non-convertible Debentures

The holders of these instruments cannot convert their debentures into shares.

Regular Income Bonds

The holders of these instruments receive regular income on their investment on monthly basis.
Deep Discount Bonds

The holders of these instruments receive a huge lumpsum amount after a stipulated long period of time.

Financial instruments are designed in such a manner as to suit the psychology of different investors.

Table 1.2
Classification of Financial Instruments

FINANCIAL INSTRUMENTS

/MONEY MARKET INSTRUMENTS
- Treasury Bills
- Commercial Bills
- Certificate of Deposit
- Commercial Papers
- Call Money

/CAPITAL MARKET INSTRUMENTS
- Shares -------- Equity Shares
  - Debentures  - Preference Shares
  - Convertible Debentures
  - Non-convertible Debentures
  - Regular Income Bonds
  - Deep Discount Bonds

Financial Intermediaries:

Financial intermediaries are individuals or institutions who operate in the financial markets by using the financial instruments. They play a vital role in the
working of financial system. Financial intermediaries can be broadly classified into two groups, Banking Institutions and Non-banking Institutions.

a) Banking Institutions:

A Bank is a financial institution, collecting deposits from the customers, and lending to the investors. In India like in all countries, banks are positively contributing to the growth of a sound financial system. With the enactment of the Banking Regulations Act 1949, the banking system was streamlined to gain public confidence. Reserve Bank of India, armed with mandatory powers, controls the banking system. Nationalisation of 20 major commercial banks in the year 1969, again another 6 banks in 1980 is the indication of socialisation of banking system. Banking facilities, through the expansion of branches, over the years has increased massively. Their number has risen from 8262 in June, 1969 to 63,346 in June, 1995. This means an addition, an average, of more than 200 branches per month. As a result of this large expansion, the people per bank has come down from 65,000 per bank in 1969 to 15,000 at present. However, as against the above mentioned positive points, there are some negative points too in the nationalisation of banks,
such as political interference, inefficiency which not only affects the profitability, it also become a threat to the survival of Banks.

The New Industrial Policy 1991 added a new dimension to the Indian economy. With the objective of market economy, privatisation has been given top priority. Banking industry is no exception to this. For the improvement of Banks Narasimham Committee made the following recommendations. Functional autonomy should be given to public sector banks. To increase the profitability, political interference should be restricted and professionalisation should be stressed.

b) Non-banking Financial Intermediaries:

The term NBFIs includes a very wide range of financial institutions other than banking companies, which are engaged in borrowing and lending. They range from such highly specialised ones as development banks and insurance companies to lease finance companies, chit funds and Private Finance Corporations. For the sake of convenience NBFIs are classified in to two groups, viz., regulated NBFIs and non regulated NBFIs.
i) Regulated NBFI:

These include Development Banks, such as IDBI, IFCI, ICICI, SIDBI and IFCs, Insurance companies and Post-Office Savings, which are mostly related to the public sector. The activities of these organisations are regulated by the government and confined to social priorities, hence these will contribute positively to the state economy.

ii) Nonregulated NBFI:

These include Money Lenders, Chit Funds and Private Finance Corporations which are mostly related to private sector. These institutions operate in unorganised markets, by their own regulated activities and create serious problems of credit control. Their credit does not conform to social priorities and hence, disturbs the over-all effectiveness of Credit Planning. In a Planned Economy, resources should be channelised to productive activities for the orderly growth of economy. In a democratic setup planning must lead, not only to economic development, but also to reduce the concentration of economic power. This is possible only when there is a stringent regulation over the financial intermediaries, more particularly in the private sector.
Table 1.3

Classification of Financial Intermediaries

FINANCIAL INTERMEDIARIES

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| BANKING INSTITUTIONS |
| | |
| NON-BANKING FINANCIAL INSTITUTIONS |
| | |
|- Regulated NBFIs ------- Development Banks |
| | |
\- Non-Regulated NBFIs |- LIC & GIC |
| | |
\- Money Lender |- Post Office Savings |
| | |
\- Chit Funds |- Non-banking Financial Companies |
| | |
\- Private Finance Corporations |

1.2 ORIGIN AND GROWTH OF PRIVATE FINANCE CORPORATIONS:

The growth of banking sector and the RBI regulations have helped the farmers and other rural folk to get redemption from the clutches of the traditional money lenders, thereby putting an end to the usurious practices of the traditional agencies.

The year 1980 witnessed a world-wide phenomenon of the establishment of NBFIs to fill the gap in demand and supply nexus in financial sector. India was no exception to this phenomenon. Taking advantage of the new situation most of the traditional money lenders
reincarnated themselves as props of the NBFIs. In Ranga Reddy district of Andhra Pradesh the year 1960 stand as a watershed in the birth of Private Finance Corporations.

In the year 1991 Indian Economy shifted its stance from Nationalisation concept to Privatisation concept. After 1991 the growth of PFCs has been phenomenal. In Ranga Reddy district of Andhra Pradesh the number of Private Finance Corporations grew from less than 100 in 1960 to more than 1000 in 1995, with a marked stress during 1991 - 1995.

1.3 IMPORTANCE OF THE STUDY:

The importance of NBFIs in the economy is significant. They play an important role, by creating financial instruments, shifting the wide and varied preferences of savers and borrowers in the economy. They influence the savings and investments. A Study Group of NBFIs was setup by the banking commission in June, 1970 - "to review the role of various classes of NBFIs, to enquire in to their structure and methods of operation and to recommend measures for their orderly growth".

The Banking Commission in its report submitted in 1972 revealed an estimated an amount of Rs 160 crores
of annual savings mobilised through different NBFls. R.G. Saraiya, the Chairman of the Banking Commission estimated in October, 1974, that the annual savings mobilised by NBFls would be between Rs.200 to Rs 250 crores as most of them are small and marginal investors.

Along with the expansion of commercial banks, there is also a parallel growth in the number the non NBFls. Hence a question arises as to, whether the NBFls thwart the efforts of the Monetory Authorities and make credit policy ineffective. To answer this an examination of the activities of the non regulated NBFls is imperative.

The recent growth in the Private Finance Corporations adds a new dimension to the picture of financial state of affairs. The rapid growth of these Private Finance Corporations requires to be probed thoroughly. These institutions, operate mostly in non urban areas and so a study of these organisations with special reference to non urban economy will be significant.
1.4 SCOPE OF THE STUDY:

The researcher has made a study of a few PRIVATE FINANCE CORPORATIONS with the emphasis on Registered Firms. This study has covered different aspects of these organisations.

Ranga Reddy district, in Andhra Pradesh (the area of the present study) was formed in the year 1978. Earlier it was a part of Hyderabad district. The Ranga Reddy district is bound on the north by Medak, on the south by Mahaboobnagar; on the east by Nalgonda district and on the west by Karnataka state. It has an area of 7493.52 KMs; 949 villages; 33 Mandalas and 3 Revenue Divisions.

It is a backward district in the Telangana region of Andhra Pradesh. It occupies a very important position due to its geographical, economic, demographic and political aspects; as well as its proximity to the state capital i.e., Hyderabad. In fact many of the offices of Ranga Reddy district are located in and around the twin cities of Hyderabad and Secunderabad.

The period of the present study is 1985 - 1995. The year 1985 was chosen as the starting period of the study because from that year there has been a perceived rapid growth of the Private Finance Corporations. The end
period is chosen as 1995 to find out the impact of privatisation of Indian economy in the year 1991. The above is a viable period for a study of these organisations.

The present study, the first of its kind in the district, aims at a study of the functioning of the Private Finance Corporations in Ranga Reddy district (A.P.), their rapid growth and their impact on rural economy.

1.5 OBJECTIVES OF THE STUDY:

1. To study the nature, structure and management, of the Private Finance Corporations, with particular reference, to rural area of Ranga Reddy district, Andhra Pradesh.

2. To study, the sources of funds and their utilisation, along with the strategies adopted for mobilisation of funds.

3. To find out the nature of the present regulations and suggest measures to strengthen it.

4. To evaluate the accounting and audit procedures.
5. To study the employment generation and working conditions of the employees and identification of customers and changes in their life styles.

6. Comparison of banking institutions with non-banking financial institutions.

7. What are the major changes that have taken place after privatisation of Indian economy in the area of rural finance.

1.6 HYPOTHESIS:

1. Inverse relationship exists between growth of Private Finance Corporations and deposits of Banks. This means that the growth of Private Finance Corporations leads to a decrease in the deposits of Banks. The growth rate of the Private Finance Corporations is greater than the growth rate of banks. The profitability of Private Finance Corporations is greater than that of banks.

2. The Private Finance Corporations are creating serious problems in the area of rural economy because of non-existing of concrete regulations to control the activities of these organisations. So, the confidence of the investors have eroded.
3. Privatisation of Indian economy may prove better than nationalisation.

1.7 METHODOLOGY:

The study is based on both types of data viz.,
i) primary data and ii) secondary data.

Primary data is collected through schedules.

Schedules:

In a survey research of this type, the schedule method will prove very useful, in order to know the views of the various parties. Five sets of schedules are prepared and used. One schedule is for the Management, second is for Employees, third is for Chartered Accountants, fourth is for Customers and the fifth is for Senior Citizens.

Published and Unpublished Reports:

Secondary data is collected from R.B.I. Bulletins, Banking Commission Reports and unpublished reports of the Private Finance Corporations.
Interview:

Information is collected from the Officials of the Finance Department, Registrar of Firms, Bank Officials and Chartered Accountants by conducting interviews.

Sample Study:

Instead of covering all the customers, a random survey is conducted in order to know the views of the customers.

Use of Library:

For a background study the scholar has visited various libraries.

Observation:

Much of the information which cannot be obtained through schedules or interviews, can be had through observation. The researcher has made number of trips to the study area, for obtaining such relevant and necessary information through observation.
1.8 REVIEW OF LITERATURE:

Non-banking Financial Intermediaries mostly operate in unregulated markets, so it is a difficult task to study these organisations. The specific literature may not be available, however various authors expressed their views regarding these organisations.

"M.Y.Khan - Indian Financial System, Vikas Publishing House, Delhi, 1980".

Around 1951 the financial system in India was immature, now financial system has come under the ownership and control of public sector. An elaborate legislative code has been designed to provide a frame-work within which private enterprise operate.

"M.C.Vaish - Monitory Theory, Vikas Publishing House, Delhi, 1973".

There are three main views regarding the NBFIs:

A. The NBFIs eliminated altogether so as to streamlining the financial system.

B. To regulate the activities of the NBFIs, establishment direct lines with the Reserve Bank of India is necessary.
C. The NBFIs should be linked with commercial banking to avoid competition in the area of finances and strengthening the financial system.

"Dr. V. S. Mahajan - Recent Developments in Indian Economy, Deep and Deep Publications, Delhi, 1984*.

The author expressed his views regarding the functioning of NBFIs. These organisations lead to the cause of concentration of economic power and inflation. It is necessary to find out a solution to counter such trend.

"K. P. M. Sundaram - Money Banking and International Trade, S. Chand & Co., Publications, Delhi, 1985*.

NBFIs should not be allowed to function without license from the Reserve Bank of India. A ratio should be prescribed between their owned funds and their deposits liabilities. Liquidity ratio should be prescribed. Ceiling on interest rates must be imposed.

"Suraj B. Gupta - Monetary Economics - Institutions, Theory and Policy, S. Chand & Co., Delhi, 1983*.

While discussing about the unregulated credit markets the author described that the rate of interest charged by these organisations is very high. NBFIs are
almost totally unsupervised and unregulated. Being the NBFIs are local in their nature, they are highly segmented.


Besides there are several other Non-Banking Agencies, which are doing some sort of banking business. These can be roughly divided into the following categories: Non-Banking Financial, Non-Financial and Miscellaneous Non-Banking Companies. These are doing such money business as conducting Prize - Chits/Lucky Draws/Savings Schemes etc. Some of these are run on some what regular basis, and have been subjected to regulations and restrictions. As all these are not managed in a very scientific manner in respect of their operations, maintenance of accounts, charges like interest, etc. These make the already unhealthy situation more unsatisfactory.


In India there are several types of unregulated Non-Banking Financial Intermediaries. These finance companies are found in all parts of the country. The
exact number of these companies is not known. In addition, a large number of partnership firms and individuals are engaged in lending business. Finance Companies generally give loans to retailers. Wholesale traders, artisans and other self employed persons. Since finance companies charge high rates of interest varying from 36 to 48 percent, normally those who borrow from these companies are persons who are unable to get credit from banks.

Most of the authors expressed similar opinion about Non-Banking Financial Intermediaries. Private Finance Corporations are operating in unorganised markets, as it is there is not much literature available on the subject.