CHAPTER - I

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I. INTRODUCTION:

Economic growth and development of any country depends upon a well-knit financial system. It provides a mechanism by which savings of small investors are transformed into huge investment. Financial system plays a significant role in the economic growth of a country by mobilising the surplus funds and utilising them effectively for productive purposes. Financial system acts as a link between the savers and the investors, thereby facilitating the flow of savings into industrial investment. The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether it be the mobilisation of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

The term financial system is a set of inter-related activities/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, investment, capital formation and growth.

Van Horne defined the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. Christy was opined that the objective of the financial system is to "supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilisation of resources without the destabilising consequence of price level changes or unnecessary interference with individual desires."
According to Robinson, the primary function of the system is "to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth."

From the above definitions, it may be said that the primary function of the financial system is the mobilisation of savings, their distribution for industrial investment and stimulating capital formation to accelerate the process of economic growth. Financial system is the system that allows the transfer of money between savers (investors) and borrowers. A Financial System can operate on a global, regional or firm specific level. Guruswamy writing in Financial Services and Systems has described it as comprising “a set of complex and closely interconnected financial institutions, markets, instruments, services, practices and transactions”.

According to Franklin ,Allen and Douglas Gale in comparing Financial Systems:

"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; they allow intertemporal smoothing of consumption by households and expenditures by firms; and they enable household and firms to share risks . The forms of financial systems vary widely but the aforesaid functions are common to the systems of most developed economies. A financial system can be defined at the global, regional or firm specific level. The firm's financial system is the set of implemented procedures that rack the financial activities of the company. On a regional scale, the financial system is the system that enables lenders and borrowers to exchange funds.

II. DEFINITION & CONCEPT OF FINANCIAL SYSTEM:

A Financial System provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange, reduces
the costs of transactions. It facilitates trade and, therefore, specialisation in production. Financial System works through its three parts i.e. Financial Assets, Financial Intermediaries and Financial Instruments. Financial assets with attractive yield, liquidity and risk characteristics encourage savings in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables an economic agent to pool, price and exchange risks in the markets. Trade, the efficient use of resources, saving and risk taking are the cornerstones of a growing economy. In fact, the country could make this feasible with the active support of the Financial Systems. The Financial System has been identified as the most catalysing agent for growth of the economy, making it one of the key inputs of development.

1. A well functioning Financial System is a sine qua non for the pursuit of economic growth with stability. The core of a well developed financial system is to facilitate smooth and efficient allocation of resources from savers to the ultimate users. An efficient financial system is a key to socio-economic development. According to Levine (1997) the financial system consists of many institutions, instruments and markets. Financial institutions range from pawnshops and money lenders to Banks, pension funds, insurance companies, brokerage houses, investment trusts and stock exchanges. Financial instruments range from the common coins, currency notes and cheques, mortgages, corporate bills, bonds and stocks - to the more exotic-futures and swaps of high finance. Markets for these instruments may be organised formally (as in stock or bond exchanges with centralised trading floors) or informally (as in over the counter or curb markets). The financial
system provides services that are essential in a modern economy. It is a core factor of development and growth. The primary role of any financial system is to act as a conduit for the transfer of financial resources from net savers to borrowers, i.e., from those who spend less than they earn to those who earn less than what they spend.

The Financial System is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether it be the mobilisation of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

Financial system provides payment services. They mobilise savings and allocate credit and they limit price, pool and trade the risks resulting from these activities. A financial systems contribution to the economy depends upon the quantity and quality of its services and the efficiency with which it provides them. The services of the Financial System make it cheaper and less risky to trade goods and services and to borrow and lend. Without these services an economy would be confined to self-sufficiency or barter, which would inhibit the specialisation in production upon which modern economics depend. The contribution of the Financial System to Growth lies precisely in its ability to increase efficiency. The system makes its biggest contribution to growth by providing a medium of exchange. It also encourages savings and provides best avenues for investments of these savings which helps to increase the income level of the economy. The economic development of any economy depends upon a multiplicity of factors and among those factors the rate of capital formation is one of the most important factor for determining the rate of growth of the economy.
A Financial System plays a vital role in the economic growth of a country. It intermediates between the flow of funds belonging to those who save a part of their income and those who invest in productive assets. It mobilises and usefully allocates scarce resources of a country. The financial system of most developing countries is characterised by coexistence and cooperation between the formal and informal financial sectors. The formal financial sector is characterised by the presence of an organised, institutional and regulated system which caters to the financial needs of the modern spheres of economy, the informal financial sector is an unorganised, non-institutional and non-regulated system dealing with the traditional and rural spheres of the economy. The existence of an efficient financial system facilitates economic activity and growth. The growth of financial structure is a precondition to economic growth. Markets, institutions and instruments are the prime movers of economic growth. The financial system of a country diverts its savings towards more productive uses and so it helps to increase the output of the economy. Besides mobilising savings, the financial system helps accelerate the volume and rate of savings by providing a diversified range of financial instruments and services through intermediaries. This results in an increased competition in the financial system which channelises resources towards the highest-return investment for a given degree of risk. This lowers financial intermediation costs and stimulates economic growth. A sophisticated financial system makes innovation least costly and more profitable, thereby enabling faster economic growth. In addition to affecting the rate as well as the nature of economic growth a financial system is useful in evaluating assets, increasing liquidity, and producing and spreading information. The financial system plays an important role in disciplining and guiding management companies, leading to sound corporate governance practices.
III. COMPONENTS OF FINANCIAL SYSTEM:


Financial intermediaries:

A significant constituent of the organisation of the financial system is an array of financial intermediaries which collect savings from others and issue in return claims against themselves and use the funds, thus raised to purchase ownership or debt claims. To quote Gurley and Shaw, the principal function of financial intermediaries is "to purchase primary securities from ultimate borrowers and to issue indirect debt for the portfolio of the ultimate lenders." Thus, they transform direct claims/primary securities into indirect securities. Primary securities are securities issued by non-financial economic units. Indirect securities are financial assets issued by financial intermediaries. As Goldsmith has aptly remarked, "Financial Intermediaries transform funds in such a way as to make them more attractive." They are attractive because they are better suited to the requirements particularly of small investors. Likewise, indirect securities are equally attractive to borrowers in the sense that they will be able to sell their securities to financial intermediaries on more satisfactory terms than selling them directly to ultimate lenders. The classification of these institutions is done on the basis of their primary activity or the degree of their specialisation with relation to savers or borrowers with whom they customarily deal or the manner of their creation. The functional, geographic, sectoral scope of activity or the type of ownership are some of the criteria which are often used to classify large number of variety of financial institutions which exist in the economy.
Financial markets:

Another significant component of the organisation of the Financial System comprises of Financial Markets which perform a crucial function in the savings - investment process as facilitating organisations. They are not sources of finance but they are a link between the savers and investors, both individual as well as institutional. Based on the nature of funds which are their stock-in-trade, the financial markets are classified into (i) Money Market and (ii) Capital/ Securities Market. Financial Markets are the centres or arrangements that provide facilities for buying and selling of individuals, and government trade in financial products on these markets either directly or through brokers and dealers on organised exchanges or off-exchanges. The participants on the demand and supply sides of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers and others, who are interlinked by the laws, contracts, covenants and communication networks. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. The corporations, financial institutions, individuals and government trade in financial products on these markets either directly or through brokers and dealers on organised exchange or off-exchanges. Financial markets are sometimes classified as primary (direct) and secondary (indirect) markets. The primary markets deal in the new financial claims or new securities and therefore they are also known as the New Issue Markets. On the other hand, secondary Markets deal in securities already issued or existing or outstanding. The primary markets mobilise savings and they supply fresh or additional capital to business units. Although secondary Markets do not contribute directly to the supply of additional capital, they do so indirectly by rendering securities issued on the primary markets liquid. Stock Markets have both the primary and secondary market segments. The Financial Markets are also
classified as Money Markets and Capital Markets. Under this classification both of these markers perform the same function of transferring resources to the producers. The conventional distinction is based on the differences in the period of maturity of financial assets issued in these markets as the money markets deal in short term claims whereas the capital markets deal in long term claims. As in accordance with the various purposes the Financial Markets may be also classified as (i) organised and unorganised (ii) formal and informal (iii) official and parallel and (iv) domestic and foreign. The financial transactions which take place outside the well established exchanges or without systematic and orderly structure or arrangements constitute unorganised markets.

Financial assets/instrumental (Securities):

The third component of the organisation of the financial system is financial assets/instruments (securities). They represent claims on a stream of income and/or assets of another economic unit and are held as a store of value and for the return that is expected. Financial Securities are financial assets representing claims to the payment of money in future; it may be the repayment of the principal and/or payment in the form of interest or dividend. A financial instrument is a claim against a person or an institution for payment, at a future date, of a sum of money and/or a periodic payment in the form of interest or dividend. The term 'and/or' implies that either of the payments will be sufficient but both of them may be promised. Financial instruments represent paper wealth shares, debentures, like bonds and notes. many financial instruments are marketable as they are denominated in small amounts and traded in organised markets. This distinct feature of financial instruments enables people to hold a portfolio of different financial assets which, in turn, helps in reducing risk. Different types of Financial instruments can be designed to suit the risk and return preferences of different classes of
investors. Financial securities are financial instruments that are negotiable and tradeable. Financial instruments differ in terms of marketability, liquidity, reversibility, type of option, return, risks and transaction costs. Financial instruments help financial markets and financial intermediaries to perform the important role of channelising funds from lenders to borrowers. Availability of different variety of financial instruments helps financial intermediaries to improve their own risk management. The securities may be direct securities (primary) or indirect securities (secondary). Direct securities are those issued by the users of the funds directly to the suppliers of funds. The various securities issued by the corporate sector are direct securities whereas the financial claims created by financial intermediaries are indirect securities. Financial securities may be also broadly classified into corporate securities and government securities. Government securities are securities issued by the government for raising a public loan or as notified in the official gazette. Financing instruments fall into one of two categories: debt and equity. Debt instruments generally represent fixed obligations to repay a specific amount at a specified date in the future, together with interest. Equity instruments generally represent ownership interests entitled to dividend payments, when declared, but with no specific right to a return on capital. In addition to the various types of conventional securities, there are derivative securities as well. These are securities whose values are deceived from the value of underlying assets. These securities are traded in a market known as the derivative market. Financial instruments differ from each other in respect of their investment characteristics which, of course, are interdependent and interrelated. Among the investment characteristics of financial assets or financial products, the following are important: (i) liquidity, (ii) market ability, (iii) reversibility, (iv) transferability, (v) transactions costs, (vi) risk of default or the degree of capital and in some uncertainty and a wide array of other risks, (vii) maturity.
period, (viii) tax status, (ix) options such as call back or buy back option, (x) volatility of prices and (xi) the rate of return- normal effective and real.

IV. FUNCTIONS OF THE FINANCIAL SYSTEM:

The Financial System facilitates allocation of resources across space and time in an uncertain environment. This primary function can be broken into the following proximate functions. Financial System:

a) facilitates separating, distributing, trading, hedging, diversifying, pooling and reducing risks.
b) allocate resources
c) monitors managers and experts corporate control
d) mobilises savings
e) facilitates exchange of goods and services, i.e. facilitates efficient operation of the payment mechanism.
f) enables economic units to exercise their time preference.
g) transmutes or transforms financial claims so as to suit the preferences of both savers and investors.
h) enhances liquidity of financial claims through securities trading.
i) facilitates better portfolio management.

Key elements of a well-functioning financial system:

The basic elements of a well-functioning Financial System are:

1. A strong legal and regulatory environment
2. Stable Money
3. Sound Public Finances and Public Debt Management
4. A Central Bank
5. A Sound Banking System

6. An Information System

7. A well functioning securities market

The functions of a modern financial systems essentially includes the following vital areas:

**Payment system:** An efficient Financial System should ensure a payment system, which would enable easy and speedy exchange of goods and services. Commercial Banks and other financial intermediaries are the major agencies which provide the payment system. The operating efficiency of these agencies saves the financial system from any break down.

**Pooling of funds:** The modern business needs large volumes of finance for expansion, diversification and undertaking new projects. At the same time, there are corporate as well as individual entities that have surplus funds. The Financial System should provide a proper link between domestic and corporate savers, and those in need of funds, so as to pool the surplus funds and channel them to productive lines. Financial intermediaries ensure pooling of funds and providing such funds to the borrowers. In other words, the financial system should provide an opportunity to small savers to participate in the larger investment portfolios by pooling their savings and ensuring them a reasonable return.

**Transfer of resources:** An efficient Financial System ensures the transfer of economic resources across time and space. The financial system provides mechanism to transfer surplus resources from the savers to other segments of the markets across time. It also accelerates the capital formation process by providing appropriate investment opportunities in corporate and government securities. The capital market segment in the Financial System helps corporate bodies to mobilise equity as well as debt from the market at
competitive costs. Capital markets also provide an opportunity to small investors to become owners of large companies. While the primary market helps corporate bodies to expand their capital base, secondary markets help them to maximise the shareholders' wealth.

**Risk management:** Multinational business operations have brought in various risk exposures, along with multi-farious business opportunities. Besides, the domestic side of business is also open to various risks. These business risks can be broadly classified as counter-party risk, credit risk, documentation risk, legal risk, system risk, country risk/sovereign risk, political risk, currency risk, interest rate risk, accounting risk and operating risk. Financial markets across the world provide different types of hedging instruments to cover such exposures. The modern finance function calls for effective use of these instruments so as to minimise risks as also to maximise the profits by taking full advantage of cross-border diversification.

**Price information for decentralised decision making:** Financial markets provide valuable information to help co-ordinate decentralised decision-making. The investors, who are spread across the country, may not get all the financial information. Financial markets, therefore, provide the required information through various publications, so that all the investors have equal access to such information.

**Price discovery process:** Buyers and sellers interact with each other in a financial market like in any other. This interaction enables the counter parties to know at what price a financial asset can be bought or sold at a mutually agreed price. They decide the required return, which becomes the benchmark return for the firms that are in need of funds. The process enables the firms to estimate the demand for funds and plan their resource mobilisation process accordingly. The financial markets thus signal how the funds in an economy
should be allocated among financial assets. This is known as the price
discovery process.

**Liquidity:** An efficient financial market should ensure easy liquidity. One of
the important considerations for investment is the ability to convert
investment into cash in case of extingencies. Financial markets provide a
platform for buyers and sellers to meet together and buy and sell securities.
This process enables an investor to get back his investment as and when he
requires it.

**Fungibility:** Financial markets convert cash into securities and back to cash
without any hurdles. Intermediaries operating in the market pool funds from
savers and issue different forms of securities which are offered for investment
in the market. Therefore, the form of funds is changed and this can be brought
back to the original form as and when required.

**V. FINANCIAL SYSTEM DESIGNS:**

A Financial System is a vertical arrangement of a well-integrated chain
of financial markets and institutions that provide financial intermediation.
Demirguc Kunt and Levine (1999) have provided explanations of bank-based
and market-based financial systems. In bank based financial systems, banks
play a pivotal role in mobilising savings, allocating capital, overseeing the
investment decisions of corporate managers, and providing risk-management
facilities. In market-based Financial System the securities markets share
centre stage with banks in mobilising the society's savings for firms, exerting
corporate control; and easing risk management. Bank-based systems tend to
be stronger in countries where governments have a direct hand in industrial
development. In India, banks have traditionally been the dominant entities of
financial intermediation. The nationalisation of Banks, an administered
interest rate regime, and the government policy of favouring banks led to the
predominance of a bank-based financial system. Arnold and Walz (2000) have attempted to identify factors leading to the emergence of bank-based or market-based financial systems. When problems relating to information persist but banks are competent enough right from the beginning and, with the passage of time, learn through experience to become more productive, they come to dominate the financial system. Conversely, if banks are initially incompetent and fail to improve themselves by experience, the bank-based system gives way to the growth of a market based financial system.

Proponents of the market-based view argue that efficiency is associated with the functioning of competitive markets. Financial Markets are attractive as they provide the best terms to both investors and borrowers. The draw-backs of the market based system are that it is more prone to instability, its investors are exposed to market risks, and that there is a free-rider problem. The last drawback arises when no individuals is willing to contribute towards the cost of something but hopes that someone else will bear the cost. This problem arises whenever there is a public good and separation of ownership from control. In a market-based system, the free-rider problem blunts the incentives to gather information. On the other hand, a bank-based system is perceived to be more stable, as the relationship between the parties is more close. This leads to the formation of tailor-made contracts and financial products and efficient inter-temporal risk sharing. Financial intermediaries can eliminate the risk that cannot be diversified at a given point of time but can be averaged over time through inter-temporal smoothing of asset returns. This requires that investors accept lower returns than what the market offers in some periods in order to get higher returns in other periods. This provides an insurance to investors who would otherwise be forced to liquidate assets at disadvantageous prices. The Banking System avoids some of the information deficiencies associated with the securities markets. The free-rider problems is
eliminated as private incentives to gather information are higher in the case of a bank-based system. The greatest drawback of a bank-based system is that it retards innovation and growth as banks have an inherent preference for low risks, low-return projects. Moreover, powerful banks may collude with firm managers against other investors, which, in some cases could impede competition, effective corporate controls and entry of new firms. The current trend is a preference for the market based system. Allen and Gale (2000) have put forward two explanations for the universal popularity of Financial Markets (i) government intervention is regarded as a negative factor and government failures are as important a problem as market failures (ii) economic theory, pertaining to firms, stresses the effectiveness of markets in allocating resources. Whatever be the type of Financial System, both financial markets and financial intermediaries play a crucial role in the development of a sound financial system. Both systems can co-exist as they encourage competition, reduce transaction, costs and improve resource allocation within the economy leading to the development of a balanced financial system.

VI. IMPORTANCE OF THE FINANCIAL SYSTEM:

The existence of an efficient financial system facilitates economic activity and growth. The growth of financial structure is a pre-condition to economic growth. In other words, markets, institutions and instruments are the prime movers of economic growth. The Financial System of a country diverts its savings towards more productive uses and so it helps to increase the output of the economy. Besides mobilising savings, the financial system helps accelerate the volume and rate of savings by providing a diversified range of Financial Instruments and services through intermediaries. This results in an increased competition in the financial system which channelises resources towards the highest returns investment for a given degree of risk. This lowers financial intermediation costs and stimulates economic growth. A
sophisticated financial system makes innovation least costly and most profitable, thereby enabling faster economic growth. Countries whose financial system encourage diverse financing arrangements are able to maintain international competitiveness through updating their productive capacities. In addition to affecting the rate as well as the nature of economic growth a financial system is useful in evaluating assets, increasing liquidity and producing and spreading information. The financial system plays an important role in disciplining and guiding management companies, leading to sound corporate governance practices. The domestic financial system when linked to the international financial system increases capital flow with the help of financial markets. This link reduces risk through portfolio diversification and helps in accelerating economic growth. A sophisticated and sound financial system accelerates the rate of economic growth and the financial system in turn develops more with higher economic growth. This relationship between financial system and economic growth has received considerable attention in empirical literature also.

VII. ORGANIZATION OF INDIAN FINANCIAL SYSTEM:

The structure of the financial system in India:

The Indian financial system is broadly classified into two broad groups:

1) organised sector and (ii) unorganised sector.

The financial system is also divided into users of financial services and providers. Financial institutions sell their services to households, businesses and government. They are the users of the financial services. The boundaries between these sectors are not always clear cut. In the case of providers of financial services, although financial systems differ from country to country, there are many similarities.
Organised Indian financial system:

The organised financial system comprises of an impressive network of banks, other financial and investment institutions and a range of financial instruments, which together function in fairly developed capital and money markets. Short-term funds are mainly provided by the commercial and cooperative banking structure. Nine-tenth of such banking business is managed by twenty-eight leading banks which are in the public sector. In addition to commercial banks, there is the network of cooperative banks and land development banks at state, district and block levels.

Unorganised Indian financial system:

On the other hand, the unorganised financial system comprises of relatively less controlled money lenders, indigenous bankers, lending pawn brokers, landlords, traders etc. This part of the financial system is not directly amenable to control by the Reserve Bank of India (RBI). There are a host of financial companies, investment companies, chit funds etc., which are also not regulated by the RBI or the government in a systematic manner. However, they are also governed by rules and regulations and are, therefore within the orbit of the monetary authorities.

Emerging financial system:

In the years to come that is the dawn of the 21st century, there is no doubt that the Indian financial system will grow in size and complexity. Different segments of the market will become closely linked and it will become difficult to influence or act on only one segment without affecting others. The major link connecting the various segments will be the interest rate as is the case in many of the industrially advanced countries now. In order to influence the entire system, the monetary authorities will have to act on interest. There will be increasing specialisation; simultaneously there can emerge financial conglomerates dealing
financial products and services. The existence of healthy and sound financial institutions should put pressure on investors and other borrowers, to use resources in an efficient and productive manner in order to repay the existing obligations and qualify for new finances.

Banks will begin to function increasingly under competitive pressures. These pressures may emanate within the banking system as well as from non-banking institutions. With the increasing participation of shareholders even in public sector banks, there will be greater accountability to shareholders, funding the Government. Competitive pressures can also result in some degree of consolidation.

Another area which will become important relates to regulatory harmonisation among various regulators, both domestic and international, of the financial markets including capital markets. Regulators will have to increase efforts towards converging their policies and procedures and have a greater element of information share.

The role of financial supervision in a system that is rapidly emerging as market based is an important one. The current supervisory approach emphasises follow-ups and compliance by the financial intermediaries with banking policy and credit allocative directives and foreign exchange regulations.

In the changing circumstances, bank supervisors will have to focus on issues which ensure the safety and soundness of the system, depositor protection and reduction of systematic risk. These are issues which will have important monetary policy implications. Ensuring compliance with prudential norms will be a major task. The supervisory system has a two fold task: it must be responsive to changes that are occurring in the financial markets and it must simultaneously instill confidence in the integrity and soundness of the markets and the participants in the market.
Conclusion:

The Indian financial system is broad-based, yet inadequate and less efficient. Efficient financial systems will help India to grow, partly by mobilising additional financial resources and partly by allocating these resources to the best uses. As economies develop, so must the financial systems that serve them.

VIII. FINANCIAL INSTITUTIONS:

Financial Institutions play a significant role in the sphere of Financial System of a country. With professional expertise and knowledge, these agencies promote the savings and investment habits of the people. They contribute to the economic and social well-being of the country by accelerating the industrial development of the country. Financial Institutions occupy a prime of place both in money market and capital market as well. Among the money market institutions Central Bank is the most important institution. This regulates and controls other financial institutions and agencies such as Commercial Banks. It controls the volume of money in circulation. It is the leader of the banking and financial system of a country. Commercial Banks constitute the pivot of the Financial System. The chief function of commercial Bank comprises accepting deposits and lending money to trade, commerce and industry. In addition, they also advance money for development of the social and priority sectors of the economy. Indigenous Financial agencies such as indigenous bankers and money lenders equally play an important role in the Banking and Financial System of India. Specialised and hybrid financial institutions that are engaged in providing long term financial and non-financial assistance to specific industrial sector are called development financial institutions. Some of the important development financial institutions are IFCI, IDBI, ICICI, SFCS, NSIC, EXIM Bank, NIDC, UTI, etc. Cooperative Banks in India also form an important
part of the Financial Institutions as they foster the need of capital requirement of the rural sector of the economy. Financial Institutions are the main constituent of a Financial System. Financial Institutions are also known as financial intermediaries because they intermediate between savers and the investors, particularly real investors. Real investors are those entities that create and use productive assets to produce goods and services for the ultimate consumers. The financial intermediaries mobilise the savings from the saving surplus units by issuing claims against themselves and lend those funds to those who are in need of them. In other words, Financial Institutions, particularly banks, provide liquidity, maturity and size intermediation. Thus, Financial Institutions can be termed asset transformers. It may be noted that the financial intermediaries do not directly add to the real capital formation in a country. But they are a necessary link between the savers and the real investors. By providing safety, profitability and liquidity for the funds saved by the savers, the financial intermediaries facilitate or encourage savings in the economy. The presence of Financial Institutions is also an assurance to the entrepreneurs that the funds will be made available at a reasonable price. Therefore, the entrepreneurs do not have to bother about the funds and can concentrate on productive activities. In this way the financial institutions facilitate the process of investment in a country. Another notable aspect is that Financial Institutions follow directives from the Reserve Bank of India which is the regulatory authority, and accordingly ensure the allocation of scarce resources in the country among various sectors in consonance with national priorities. The institutions in the financial markets such as commercial banks and non-bank intermediaries undertake the important process of financial intermediation whereby the funds or savings of the surplus sectors are channeled to deficit sectors. Intermediary services are of two kinds: brokerage function and asset transformation activity. Brokerage function is represented
by the activities of brokers and market operators; processing and supplying information is a part and parcel of all intermediation by all institutions. Brokerage function brings together lenders and borrowers and reduces market imperfections such as search, information and transaction costs. The asset transformation activity is provided by institutions issuing claims against themselves which differ from the assets they acquire. Mutual Funds, insurance companies, banks and depository institutions undertake the transformation by providing many depositors with a share of a large asset or issuing debt type liabilities against equity type assets. While providing asset transformation, financial firms differ in the nature of transformation undertaken and in the nature of protection or guarantees which are offered. Banks and Depository institutions offer liquidity, insurance against contingent losses to assets and mutual funds against loss in value of assets. Through their intermediary activities, Banks provide a package of information and risk-sharing services to their customers and while doing so they take one part of their risk. Financial institutions provide three transformation services. Firstly, liability and asset size transformations consisting of mobilisation of funds and their allocation. Secondly, maturity transformation, by offering the savers a relatively short term claim or liquid deposit they prefer and providing borrowers long term loans which are better matched to the cash flows generated by their investment. Finally, risk transformation by transforming and reducing the risk involved in direct lending by acquiring, more diversified portfolios than individual savers can. Financial intermediaries economise cost of borrowers and lenders.

Types:

Financial institutions may be broadly categorised into two groups i.e. Money market institutions and Capital Market institutions. Money market institutions refer to those financial institutions which cater to the notions of
savers of high liquidity and safety along with portability and which provide working capital to trade and industries mainly in the form of loans and advances. Capital Market financial institutions supply medium and long term resources to borrowers. These institutions may be further be classified into lending institutions and development banks on the basis of the nature of their activities and the financial mechanism adopted by them. Investing institutions comprise those financial institutions which garner the savings of the people by offering their own shares and stocks and which provide long-term funds, especially in the form of direct investment in securities and underwriting capital issues of business enterprises. These institutions include investment banks, merchant banks, investment companies and the mutual funds and insurance companies. Development banks include those financial institutions which provide the sinews of development, i.e. capital, enterprises and know-how to business enterprises so as to foster industrial growth. Financial institutions may be further classified also as Banking and Non-Banking Financial institutions. Thus, each kind of financial institution has a special role to play in the economy commercial banks mobilise, pool and channelise savings into productive activities, thereby contributing to the economic growth of the country.

Thus from the above discussion on the Financial Institutions the special characteristics of the Financial Institutions may be summed up as follows:

1. **Saving and Investment Agencies:** Financial Institutions are principally concerned with collecting the savings from the multitude of small savers and challenging them into productive investment avenues. In fact, financial institutions serve as an effective link between savings and investment. Moreover, they adopt numerous ways and forms for mobilising the savings of different types of persons and transferring the funds thus mobilised to different types of entrepreneurs to satisfy their varied needs.
2. **Professional Skills:** A redeeming feature of the Financial Institutions is that they possess all the required professional knowledge and expertise needed to carry out the special activity of catering to the credit needs of different sectors of the economy.

3. **Safety, liquidity and profitability:** Financial Institutions provide efficient market ability and liquidity of securities that are traded in the stock market. In addition, they also provide safety and profitability of the funds handled by them.

4. **Financing:** Financial Institutions provide working capital to trade and industry mainly in the form of loans and advances.

5. **Role of Money Market:** Financial Institutions play an important role in the money market by ensuring tactful balancing of demand and supply of funds.

6. **National Importance:** Financial Institutions make available continuous and uninterrupted supply funds for setting up new industries and also for the expansion and modernisation of existing industries. This way they contribute to the accelerated industrial and economic development of the country.

**IX. FINANCIAL SERVICES:**

Financial Services enable organisations to meet their short and long term financial requirements. Institutions known as financial products deliver these products. Financial services available to investors find profitable avenues of investing and at the same time extend financial assistance to industrial, business and domestic borrowers. Financial services form a part of various services like hospitals, hotels, travel and tourism, repairing, consultancy etc. The American Marketing Association (AMA) has described services as "activities, benefits or satisfactions which are offered for sale, or are provided in connection with the sale goods." The well known marketing guru Philip Kotler has defined services as "......... any activity or benefit that
one party can offer to another that is essentially intangible and does not result in the ownership of anything. Its production may or may not be tied to a physical product". Financial services can be defined as the services provided by financial institutions to investors and borrowers. The type of services differ from person to person – the need of the hour deciding the type of service. Financial services differ from other types of services in their basic structure and form. Financial services are those that help with borrowings and funding, lending and investing, buying and selling securities, making and enabling payments and settlements, and managing risk exposures in financial markets. The major categories of financial services are funds intermediation, payments mechanism, provision of liquidity, risk management and financial engineering. Some of the major characteristics of Financial Services are :-

1. **Intangibility:** Financial Services are invisible, whereas, in the case of other services like repairing, construction, etc., they can be observed in their physical form. Unlike commodities, financial products cannot be seen or verified and their suitability in satisfying our needs cannot be confirmed before the services are availed.

2. **Derivatives and Catalysts:** Financial services are derivatives of financial markets. They form a part of the financial market and are, to an extent, catalysts in market operation. They activate market operation and promote a better investment climate, thereby attracting more domestic savings for a higher rate of capital formation. They contribute various financial products derived from various financial transactions.

3. **Link:** Financial services act as a link between investor and borrower. They provide various avenues to the investor for profitable investment and spreading out the risk. An investor can
exercise a high risk and high profit, or low risk and low profit option or can be satisfied with a steady income pattern with reasonable risk. The borrowers on the other hand are provided with various products to satisfy their financial requirements by reducing their cost of funds, while at the same time, structuring the repayments in tune with the income pattern.

4. Distribution of Risks: Financial services make profitable deployment of funds and enable the investors to distribute risks in multi baskets, thereby, assuring a minimum rate of return. Their market expertise enables them to advise investors in the selection of portfolios for an assured return.

5. Assistance to Investors: Financial Services with their expertise in appraisal, help the investors assess various risks. Therefore, investors need not have expertise or infrastructure for handling their investment portfolios.

6. Inseparability: Financial services are typically sold, produced and consumed unlike physical commodities which are first produced, stored and distributed through the wholesale and retail outlets and then consumed. In the case of services, the client is also present as the service is produced and therefore are mostly tailor-made. Another special feature is the client-provider interaction.

7. Agent: Financial Services act as agents of investors, as well as agencies in need of funds.

8. Heterogeneity: Unlike physical commodities Financial Services are difficult to standardise. Even standardised services need a personal touch, because they depend upon the provider and when and where they are provided Financial Services vary from one person to
another. The type and quality of services depend upon the perception of consumers.

9. **Perishability**: Financial services are still born and cannot be stored as in the case of commodities. In addition, there is a fluctuating demand in case of some services, which may aggravate the perishability feature. A service once produced, cannot be replicated because the services are provided according to the need of the client, which may differ from time to time, even with the same client. Services are consumed as soon as they are produced differently to meet the requirements of different persons. Therefore, the services cannot be stored. Unlike physical goods they are difficult to be replaced or repaired.

Financial services are broadly classified into wholesale Financial Services and Retail Financial Services, based on the profile of users. These are further classified into Asset Based Financial Services and fee based financial services. Wholesale financial services are services availed by industry and business people, which are utilised for conversion into final retail products directly or indirectly. Retail Financial Services on the other hand are those provided to the individuals and directly put to consumption needs. When Financial Services are used for creating assets or are supported by assets where the funds are transformed into assets they are known as Asset based Financial Services. However, fee based financial services do not create immediate funds, they enable the creation of funds through their services for which they charge a fee. The Asset based Financial Services and the Fee Based financial services can be also further classified into wholesale and retail basis i.e. the services available to the corporate sector and the services available to the retail sector. The Asset based corporate Financial Services include leasing and hire purchase, asset securitisation, mortgage loans,
working capital finance, bill discounting, factoring, forfeiting, commercial paper, certificate of deposits, corporate banking services, bonds and debentures, gilt edged securities, structured notes like credit linked notes, revolving under writing facilities, note issuance facility etc. Asset based corporate services enable the corporate entities to mobilise resources at cheaper rates as well as open up investment opportunities with enhanced returns. Asset based retail financial services consist of the financial services availed for creation of assets. These can be loans or deposits. The loans include personal finance, consumer finance, housing finance, automobile finance, educational loans, mortgage loans, purchase/discounting of cheques and drafts etc. The latest arrival in the loan category is the reverse mortgage aimed at senior citizens. Fee based corporate financial services are the services offered to corporate customers by financial institutions. These services are the services offered to corporate customers by financial institutions. These services include guarantees, letters of credit, bills co-acceptance facility, credit insurance, credit syndication, corporate restructuring, credit syndication, corporate restructuring, credit rating, electronic fund transfer, cash management services and venture capital finance. Fee based retail financial services may be also termed as personal financial service. The major Fee based retail financial services are personal tax counselling, credit cards, debit cards, smart cards, barter cards, ATM, foreign inward remittances, foreign outward remittances, fund transfer facilities, safe deposit lockers, safe custody facilities, certifications, portfolio management and bancassurance.

X. FINANCIAL INSTRUMENTS:

A Financial Instrument is a claim against a person or an institution for payment, at a future date, of a sum of money and/or a periodic payment in the form of interest or dividend. The term 'and/or' implies that either of the
payments will be sufficient but both of them may be promised. Financial instruments refer paper wealth shares, debentures, like bonds and notes. Many financial instruments are marketable as they are denominated in small amounts and traded in organised markets. This distinct feature of financial instruments has enabled people to hold a portfolio of different financial assets which, in turn, helps in reducing risk. Different types of financial instruments can be designed to suit the risk and return preferences of different classes of investors. Savings and investments are linked through a wide variety of complex financial instruments known as 'securities'. Securities are defined in the Securities Contracts Regulation Act (SCRA), 1956 as including shares, scrips, stocks, bonds, debentures, debentures stocks or other marketable securities of a similar nature or of any incorporated company or body corporate, government securities, derivatives of securities, units of collective investment scheme, security receipts, interest and rights in securities, or any other instrument so declared by the Central Government. Financial securities are financial instruments that are negotiable and tradeable. Financial securities may be primary or secondary securities. Primary securities are also termed as direct securities as they are directly issued by the ultimate borrowers of funds to the ultimate savers. Primary or Direct Securities include equity shares and debentures. Secondary securities are also referred to as indirect securities, as they are issued by the financial intermediaries to the ultimate savers. Bank deposits, mutual fund units and insurance policies are secondary securities. Financial instruments differ in terms of marketability, liquidity, reversibility, type of option, return, risk and transaction costs. Financial instruments help financial markets and financial intermediaries to perform the important role of channelising funds from lenders to borrowers. Availability of different varieties of financial instruments - helps financial intermediaries to improve their own risk management. Financial instruments,
also known as financial products, are the vehicles through which investments are made. Hence they are investment vehicles. The financial assets instruments fall into three broad categories: (i) Direct/primary, (ii) Indirect and (iii) Derivatives.

XI. GROWTH OF THE INDIAN 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 liberalised/deregulated/globalised economic environment.

Phase I: Pre. 1951 organisation:

The organisation of the Indian financial system before 1951 had a close resemblance with the theoretical model of a financial organisation in a traditional economy, as formulated by R.L. Bennet A traditional economy, according to him, "is one in which the per capital output is low and constant."

The principal features of the pre-1951 financial systems were aptly described by L.C. Gupta as: "The principal features of the pre-Independence industrial financing organisations are the closed-circle character of industrial entrepreneurship: a semi-organised and narrow industrial securities market, devoid of issuing institutions and the virtual absence of participation by intermediary financial institutions in the long-term financing of the industry." As a result, the industry had very restricted access to outside savings. The fact that the industry had no easy access to the outside savings is another way of
saying that the financial system was not responsive to opportunities for industrial investment. Such a financial system was dearly incapable of sustaining a high rate of industrial growth, particularly the growth of new and innovating enterprises.

**Phase II: 1951 to mid-eighties organisation**

In sharp contrast to the position around 1951, when the organisation of the financial system left much to the desired, the ability of the system to supply finance and credit to varied enterprises in diverse forms was greatly strengthened during the second phase. The organisation of the Indian financial system during the post-1951 period evolved in response to the imperatives of planned economic development. In pursuance of the broad economic and social aims of the State to secure economic growth with social justice as enshrined in the Indian Constitution, under the Directive Principles of State policy, the scheme of planned economic development was initiated in 1951. The introduction of planning had important implications for the financial system. With the adoption of mixed economy as the pattern of industrial development, in which a complementary role was conceived for the public and private sectors, there was a need for an alignment of the financial mechanism with the priorities laid down by the Government's economic policy. In other words, planning signified the distribution of resources by the financial system to be in conformity with the priorities of the five-year plans. The requirement to allocate funds in keeping with the corresponding pattern implied Governmental control over distribution of credit and finance. The main elements of the financial organisation in planned economic development could be categorised into four broad groups:

(I) Public Government ownership of financial institutions,

(ii) Fortification of the institutional structure,
(iii) Protection to investors and
(iv) Participation of financial institutions in corporate management.

The year 1909 was a landmark in the history of public control of the private financial institutions, when fourteen major commercial banks were brought under the direct ownership of the Government of India.

New Institutions In addition to nationalisation, the control of public authorities on the sources of credit and finance led to the creation of a battery of new institutions in the public sector. In the first place, a number of powerful special-purpose financial institutions designated as development banks/development finance institutions/term-lending institutions were set up.

Another step of considerable significance was the creation of an investment trust organisation - the Unit Trust of India - in the public sector. The only other important pool of savings, namely, pension and provident funds, were for all purposes under the control of the Government, in terms of the regulations governing their investments. Thus, the public sector occupied a commanding position in the industrial financing system in India, that is, virtually the entire institutional structure was owned and controlled by the Government.

The most significant element in the emergence of a fairly well-developed financial system in India during the second phase was the strengthening of its institutional structure. The fortification of the institutional structure of the Indian financial system was partly the result of modification in the structure and policies of the existing financial institutions, but mainly due to the addition of newer institutions as detailed in the discussions that follow.

The setting up of a variegated structure of development banking/finance/term-lending institutions was the most outstanding
development in this sphere. This was because in quantitative terms, they grew into a massive source of industrial finance, and as the most important supplier of capital during the period under reference, they could be appropriately designated as the backbone of the system of industrial financing in India.

With the entry of the Unit Trust of India in 1964, the capital market activity of the LIC witnessed a sharp decline in terms of purchases of securities since the early seventies. This was mainly due to the changes in the regulation governing the investment of such funds, coupled with the traditional conservation of life insurance companies which was reinforced in the case of the LIC by the Mundhra episode of 1957.

Another innovation during this phase was the entry of commercial banks in the field of underwriting of new corporate issues.

Apart from term loans and underwriting of issue of capital, the banks also widened their range of financial assistance to the industry partly through direct subscription to the shares and debentures of corporate enterprises and partly through their lending against such securities.

The enactment of the Companies Act, 1956 represented an important stage in the development of corporate enterprises in India. It intended to weave an integrated pattern of relationship as between promoters, investors and management.

The second element in the scheme of providing protection to the investing public was the Capital Issues (Control) Act, 1947. The control aimed at fostering a rational and healthy growth of the corporate sector by ensuring that the investment did not go into channels which were wasteful and not in accordance with the objectives of the plans; and that companies had a capital structure which was sound and conducive to the public interest.
The Securities Contracts (Regulation) Act, 1956 provided for reforms in stock exchange trading methods and practices which were the subjects of controversy in the past. The main objective of this Act was to have a healthy and strong investment market in which the public could invest their savings with full confidence.

The Monopolies and Restrictive Trade Practices Act also came into force from June 1, 1970. The Act certainly contributed to restoring public confidence in the corporate sector.

The Foreign Exchange Regulations Act (FERA), 1973, regulated foreign investment with the aim of diluting the equity holding in foreign companies. It was also a step in the direction of engendering confidence among the investing public in industrial securities.

To sum up the emerging trends in the organisation of the Indian financial system between 1951 and the mid-eighties, the financial system in India was immature initially, a broad-based and diversified organisation gradually came into being. In the first place, an institutional structure with considerable strength and repute capable of supplying industrial capital to various enterprises in diverse forms was gradually built up. With the fortification of the structure by moulding the operational policies of the existing institutions, and by the setting up of a variety of newer institutions, the whole financial system had come under the ownership and control of public authorities so that the public sector occupied a commanding position in the distribution of credit and finance to private industrial enterprises in India. Such a control was viewed as an integral part of the strategy of planned economic development. Also, an elaborate legislative code was designed to provide a framework within which a private enterprise was to operate and progressively develop. Another development of considerable significance in this respect was the participation
of the financial institutions in the management and control of the companies to which finance was provided. Thus, the problem of industrial financing in India was, until the fifties, the lack of a broad-based, efficient and responsive distributive mechanism. The task of creating such a mechanism was accomplished during the sixties to the eighties.

The crying need of the Indian financial system after the mid-eighties was the integration of the distributive mechanism with the ultimate pool of savings of the community. This could be achieved through encouragement to the growth of institutions like mutual funds which were organically linked with the source of savings, as well as modification in the regulation governing the investment of funds of insurance organisations, pension, provident and other trust funds which pre-empted their investments in the Government approved investments. It was also necessary to promote diversification in the form of financing of industrial enterprises with greater focus on equity/risk capital to reflect larger stake to promoters, and the implicit financial discipline. Yet another requirement was the injection of norms of: financial prudence in their financing operations, and the observance of internationally accepted accounting standards relating to capital adequacy, asset classification, provisioning and income recognition, by the development financial institutions.

Phase III: post-nineties organisation

The organisation of the Indian financial system, since the mid-eighties in general, and the launching of the new economic policy in 1991 in particular, had been characterised by profound transformation. The fundamental philosophy of the development process in India shifted to free market economics and the consequent liberalisation/deregulation/globalisation of the economy. Major economic policy changes such as macro-economic stabilisation, delicensing of industries, trade liberalisation,
currency reforms, reduction in subsidies, financial sector/capital market/banking reforms, privatisation/disinvestments in public sector units, tax reforms, and company law reforms in terms of simplifications and debureaucratisation were gradually implemented, and they have had far-reaching impact on the structure of the corporate industrial sector in India. In such an emerging economic scenario, the role of the Government in economic management did obviously shrink, and with greater momentum in the process of economic liberalisation/globalisation, the relative importance of the Government in this sphere declined further. As a logical corollary, the role of the Government in the distribution of finance and credit was marked by a considerable decline and the organisation of the Indian financial system, dominated until the mid-eighties by state control, was witnessing capital market-oriented developments/reforms. The capital market emerged as the main agency for the allocation of resources and all segments of the Indian economy like the public sector, private sector, and state governments were competing to raise resources in the capital market. The notable developments in the organisation of the Indian financial system during this phase were (I) privatisation of financial institutions, (II) reorganisation of institutional structure and (ill) investor protection.

While practically the entire financial system was under the state ownership and control till the mid-eighties, steps were initiated during this phase to privatise important financial institutions. An outstanding development in this sphere was the conversion of the Industrial Finance Corporation of India - the pioneer development finance institution in the country - into a public company (IFCI Ltd). This was indeed, a revolutionary change in the organisation of the Indian financial system.
Reorganisation of institutional structure:

Apart from the entry of private financial institutional structure of the Indian financial system had undertaken an outstanding transformation to reflect the capital market-orientation in its evolution.

Nonetheless, some positive developments can be discerned in the banking/financial system.

A segment of the Indian financial system that had witnessed the most profound transformation was the securities market. Historically, India's capital market was dormant till the mid-1980s. The long-term needs of the corporate sector were by and large, met by the DFIs as well as other investment institutions, namely, LIC and UTI. Activities in the capital market were limited mainly due to the administered structure of interest rates and easy availability of credit loans from banks and FIs. From being a marginal institution in the mid-eighties, the securities market emerged as the most important mechanism for allocating resources in the economy. The emerging significance of the security markets was eloquently borne out by the rapid expansion in the quantum of funds raised and the number of investors in the primary market, as also by the increase in the number of stock exchanges and listed stocks, speedy rise in market capitalisation and the volume of trade and entry of sophisticated investors like the foreign institutional investors and the mutual funds. India's capital market transformed into one of the dynamic capital markets of the world. The structure of both the segments of the market - primary/new and secondary/stock exchange witnessed significant changes.

The securities market which emerged from the periphery to enter the mainstream of the financial market in India, had been one of the most significant institutional developments since the mid-eighties, especially since the beginning of the nineties. It witnessed a spectacular growth and to help
sustain this growth and crystalline the awareness and interest into a committed, discerning and growing pool of investors, the investors' right must be fully protected, trading malpractices must be prevented and structural inadequacies of the market must be removed.

Although a fairly comprehensive legislative code had been put a place in the pre-1990 phase, the focus was on control. The framework was fragmented, both in terms of the laws/acts under which the regulatory functions fell and the agencies and Government departments that administered them.

The need of the growing securities market in India was a focussed/integrated regulatory framework and its administration by an independent/autonomous body. The Capital Issues (Control) Act was repealed in 1992 and the Office of the Controller of Capital Issues (CCIs) was abolished. The Securities and Exchange Board of India (SEBI) was set up in April 1988 by an administrative order and acquired a statutory status in 1992. It had emerged as an autonomous and independent statutory body with a definite mandate which requires it to (i) protect the interest of the investors in securities; (ii) promote the development of the securities market; and (iii) regulate the securities market. In order to achieve these objectives, SEBI exercised powers under : (a) the SEBI Act, (b) the Securities Contracts (Regulation) Act, (c) the Depositories Act and (d) the delegated powers under the Companies Act. The SEBI regulates and supervises the securities markets through (1) regulations (2) guidelines (3) and schemes and has been continuous doing so since its formation.