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FINANCIAL SYSTEM IN INDIA

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ABSTRACT

A financial system of any country refers to a system that helps in creation of wealth by establishing a smooth and efficient relationship between the borrowers and the lenders by linking savings with investments. The financial system plays an important role in the economic development of a country by accelerating the process of capital formation. This paper speaks about the details of Indian financial system and its organization structure. The study walks you through the organized or formal financial system and unorganized or informal financial system in India. The report not only gives insights into the Indian financial institutions and markets, its classifications and key players, but also contains history and development of the Indian financial institutions. The paper contains sufficient information to educate the reader about the different aspects of the Indian financial system such as financial institutions, financial markets, financial instruments, financial services and informal financial system of India. An overview of the present scenario towards the end provides a better understanding of the concept of Indian financial system to the readers.

KEYWORDS: Financial system, Financial markets, Financial institutions.

Financial System in India

INTRODUCTION

Money and finance play an important role in daily life and in every activity of individuals. Access to finance is the ability of individuals or enterprises to obtain financial services including credit, payment, deposit, insurance and other risk management services. Financial system functions as an intermediary and facilitates the flow of funds amongst the various units of the system. The financial system helps to pool and mobilize savings. Financial system plays an important role in economic growth and development of the nation. The word 'system' in the term "financial system" includes a set of complex and interrelated financial institutions, financial markets, financial instruments and financial services. Financial access and an efficient financial system benefits the economy by promoting the economic growth, intensifying competition and also boosting demand for labor.

Objective of the study

This research paper has three main objectives which are carefully outlined hereunder:

1. To study the Indian Financial System.
2. To study the various components of Indian Financial System in detail.
3. To learn about the current scenario of Indian Financial System.

Data and Research Methodology

The study concentrates basically on the Indian Financial System and its key components. Secondary data has been used for the purpose of this study. The information related to the study are taken from the journals, articles, research papers and books written by different research scholars and eminent authors.

Review of Literature

Levine (1997) in her study explains the effect of financial system on economic growth and has given a functional approach which highlights the relation between economic growth and the functions of the financial system.

Hanson and Kathuria (1999) in their study provided the importance of legal, regulatory and supervisory issues in reform and discussed about India's shift from financial repression to financial liberalization. They have also explained about interrelated challenges faced by India since the time of financial sector reforms.

Allen, Chakrabarti and De (2007) in their study explains that India remains a developing country with all its sheen capital market performance, although the financial system excludes about 40% of the population. They also points out at the efficiency of the Indian financial sector, privatization progress, major changes in banking sector and the importance of microfinance for a profitable method of poverty alleviation and economic development of India.

Khatua and Pradhan (2014) provided an understanding of overreaction effects which enables investors to prepare different trading strategies to earn contrarian profits or increased returns from the overreaction and reversal effects. It is concluded that overreaction is more eminent in case of unspecified events than specified events.

Narasimhan and Kalra (2014) in their study discusses the impact of derivative trading on liquidity in the Indian Stock Market by using price-impact based liquidity measure. The results showed a shift in volume from cash market to derivatives market with a decline in the number of trades, increase in liquidity of stocks and lower volatility after the introduction of derivative trading. It was also concluded that the impact of derivative trading on long-term liquidity of the market depends on the level of liquidity prior to the introduction of derivative trading.

Introduction to Indian Financial System

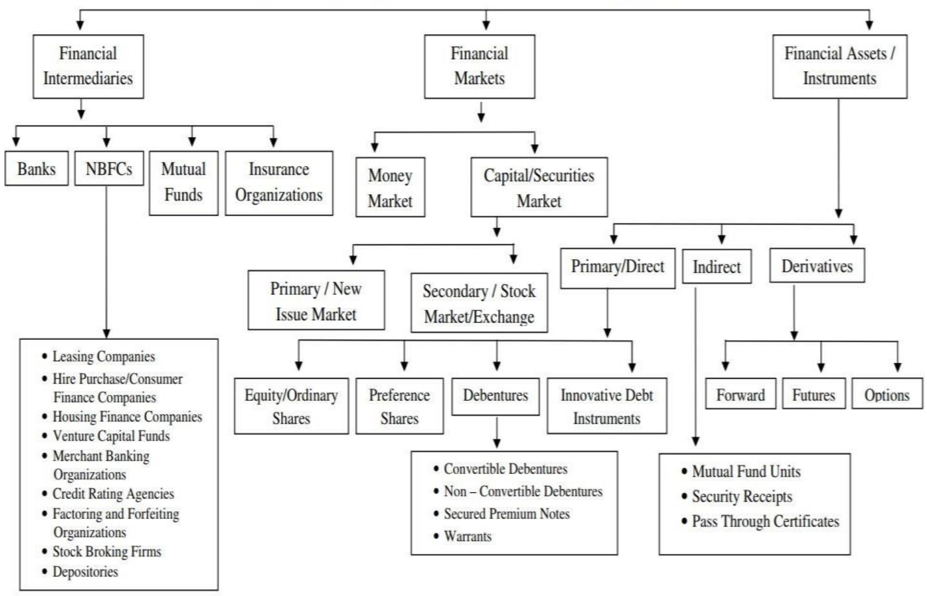
A Financial System of any country refers to a system that provides smooth and efficient relationship between the borrowers and the lenders. This system aims at establishing effective medium for generating funds from various sources. A financial system may be defined as a set of institutions, instruments and markets which fosters savings and channels them to their most efficient use. The main function of this financial system is to assemble wide spread savings from household individuals and industrial firms. This system helps in fastening the process of capital formation. This further accelerates process of economic prosperity of any nation. Financial System includes various aspects such as financial markets, financial institutions, banking firms, financial services, financial intermediaries, financial assets and instruments, etc. All these are closely related and work in combination with each other. An efficient and innovative financial system is very essential for fast and continuous growth of the economy. Financial system provides a useful link between investors and depositors. It encourages both rates of savings as well as investments. Thus, it plays a very important role in overall functioning of whole economy. Dynamic and flexible financial markets are essential for creating balance and successful growth in financial system in a country. In India since independence, financial sector has been operating under strong Government control. For a period of more than four decades, Government had direct control over all the financial institutions and financial markets, which includes capital market and money market. During this period, Government of India directed various credit programs, control pricing of financial assets, framed different bank regulations and formed number of barriers for entering into different sectors. Government also restricted number of financial transactions as well as flow of funds within and outside the economy. All these resulted in growth of highly segmented, but inefficient financial markets. This is mainly because of inflexible and strict restrictions under Foreign Exchange Regulation Act (FERA).

Large number of financial sector reforms was undertaken during 1990s. The main objective was to build an effective and operationally efficient financial market in India. These reforms targeted fundamental restructuring in Indian economic system by including industrial deregulation, liberalization of policies relating to foreign direct investments, foreign institutional investments, etc. The reforms were undertaken in various segments such as commercial banking, capital markets, foreign exchange management, mutual funds, stock markets, non-banking financial services, etc. Primary focus of these reforms was to remove structural weaknesses and increase competitiveness to ensure development of domestic financial markets and to link it to the global economy. These reforms also aimed at improving market efficiency, adequate and timely distribution of required information, reduction of transaction costs, reducing government intervention, improving financial feasibility, strengthening up financial institutions, etc. This helped in achieving higher level of efficiency in market operations and increased effectiveness of monetary policies implemented in India.

Formal Financial System

It is also known as organized financial system and comes under the supervision of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI) and other regulatory bodies. Formal financial system can be divided into four sub-systems. They are: Financial Institutions, Financial Markets, Financial Instruments and Financial Services.

Figure 1.1 – Organization of Indian Financial System [4]



[4] Khan M. Y; "*Indian Financial System*", Tata McGraw Hill Publishing Co. Ltd, New Delhi, Fifth Edition, 2007, p – 1.5

Figure 1.1 shows the organization structure of Indian formal financial system which consists of Financial Intermediaries, Financial Markets and the Financial Instruments.

Financial Intermediaries

Financial intermediaries are an important link between the issuers of securities and the investors in securities. They act as a middleman between the borrowers of money who are companies and government and lenders of money who are retail and institutional investors. They take money from the savers (or lenders) and loan it directly or indirectly to the borrowers (Government / businessmen). Banks, insurance companies, pension funds, mutual funds etc. are the examples of financial intermediaries. Some of the important intermediaries in Indian capital market are merchant bankers, underwriters, registrars and share transfer agents, bankers to an issue, debenture trustees, stock brokers and sub brokers, portfolio managers and others.

History and Development of Financial Institutions

Enhancement of the RBI Act 1935 brought forth many scheduled banks in India, some of which had already been established around 1881. The first bank which was established with Indian ownership and management was the Oudh Commercial Bank, formed in 1881, followed by the Ayodhya Bank in 1884, the Punjab National Bank in 1894 and Nedungadi Bank in 1899. Thus, there were only five Banks in existence in the 19th century. During the period 1901-1914, twelve more banks were established, prominent among which were the Bank of Baroda (1906), the Canara Bank (1906), the Indian Bank (1907), the Bank of India (1908) and the Central Bank of India (1911).

In 1913 and in 1929, the Indian Banks faced serious crises. Several banks succumbed to these crises. Public confidence in banks received a jolt. About twenty scheduled banks came into existence after independence, two in public sector and one in private sector. Certain non-scheduled banks were included in the second schedule of the Reserve Bank and the number of scheduled banks rose to 81 out of which almost 23 banks were either liquidated or merged or amalgamated with other scheduled banks in 1968, leaving 58 Indian schedule banks.

Until 1935 when RBI came into existence to play the role of Central Bank of the county and regulatory authority for the banks, Imperial Bank of India played the role of a quasi-central bank. It functioned as a commercial bank but at times the Government used it for regulating the money supply by influencing its policies. Thus, the role of commercial banks in India remained confined to accelerating the community's savings and attending to the credit needs of only certain segments of the economy.

Indian Financial Market

Financial market is an institution that facilitates buying and selling of financial instruments like government bonds, debentures, deposits and loans, corporate stocks, futures, options and other such financial products. These transactions may take place either at a specific place or through other modern electronic mechanism. In financial market, monetary funds are transferred from surplus to deficit. A financial market consists of different players which includes borrowers, lenders, banking institutions, non-banking organizations, investors, agents, brokers, etc.

According to Brigham, Eugene F, “The place where people and organizations wanting to borrow money are brought together with those having surplus funds is called a financial market.” Financial markets play an important role in gathering investible funds for those in need of investment. Generally, household individuals who have excess funds or savings lend them to borrowers in corporate or public sectors.

Main function of financial markets includes providing appropriate and sufficient funds to borrowers for enabling them in carrying out their investment activities. On other hand, it provides required expected returns to the lenders of funds. This enables them to earn wealth by investing their funds in productive projects. In simple words, the financial markets facilitate proper and timely transfer of real economic resources from lenders to the ultimate borrowers. This helps to increase both National Income as well as Gross National Production by ensuring easy liquidity of financial assets. Financial market plays an important role in economic growth and development of a country by ensuring free and unrestricted flow of surplus funds into productive investments. It helps in allocation of scare financial and economic resources. It directs the resources in productive sectors by transferring them from savers to borrowers. Thus, it increases overall investment activities in the country.

Classification of Indian Financial Markets

Today, Indian financial markets are more advanced and organized as compared to other sectors in the country. The domestic financial market plays an important role in accelerating household savings which further helps in implementing various economic and financial policies framed from time to time. Furthermore, these markets are well developed and are capable of overcoming different phases of economic cycles. There are a number of financial products and instruments operating in these markets, prices of which are openly determined by large number of buyers and sellers. Indian financial market acts as a mediator between household and business organizations. As a barometer of domestic economy, financial markets facilitate to measure the pace of economic growth and development of the country.

Indian financial markets are broadly classified as follows:

- Capital Markets: This includes stock markets that makes the capital funds available to different corporates through issuing of equity shares. Also, it facilitates transfer and exchange of such securities among different individuals.
- Bond Markets: This makes capital funds available through issuing of debt securities like bonds and debentures. Like capital markets, it also facilitates exchange of debt securities among different people.
- Commodity Markets: This allows trading and exchange of various kinds of commodities and products.
- Money Markets: This helps in assembling short term finance for the purpose of short term investments.
- Derivative Markets: In this market, financial instruments are traded wherein the financial risk involved is comparatively low.
- Futures Market: This provides forward contracts for trading financial products that shall be executed on a future date.
- Insurance Market: It facilitates operations of various insurance companies with main objective of reducing various kinds of risks involved.
- Foreign Exchange Market: It allows transactions related to various foreign currencies and reserves.

Key Players in Financial Market

- Household Individuals: This segment includes wage earners, salaried employees, housewives, service person, students, retired persons, etc. who demand funds to meet their needs of investments such as housing, education, marriage and other day to day requirements. Supply of funds results from their savings. They save for retirement benefits, for meeting expenses during emergencies, etc. The demand and supply of funds of this segment is mainly influenced by demographic factors like age, gender, earnings, income, marital status, family background, perceptions, etc.
- Business Enterprises: This includes various business firms operating in the country. Their demand for funds arises for two types of investment - short term requirements (working capital) and long term investments (capital expenditure). They meet their funding needs either through borrowings from outside or through their accumulated reserves and surplus earned previously. Their demand and supply of funds depends on factors like unexpected

risks and returns, industrial and economic policies, government policies, investment opportunities, etc.

- Government: Central, State and Local Governments play a key role of both borrowers and lenders of funds in functioning of financial markets. One of the methods of Government financing includes deficit financing. Government begins to lend funds as soon as surplus is generated i.e., when revenues exceeds expenditures. There are also other factors that determines the demand and supply of funds.
- Financial Intermediaries: Efficiency of Indian financial markets depends mainly on existence of active and efficient functioning of financial intermediaries in the economy. These financial intermediaries include banking organizations, non-banking firms, financial institutions, insurance companies and others. They are involved in allocating of assets and play an important role in eliminating market imperfections.
- External Agencies: In addition to domestic agencies, there are certain external agencies that include foreign investors, foreign banks and financial institutions, foreign companies, etc. They facilitate International borrowings and lending and are determined by factors such as economic policies, transactions costs, etc. Foreign exchange market facilitates borrowing and lending of foreign currencies.

Financial Instruments

Financial instruments or assets are the third important component of Indian financial system. They represent claims on income or asset and are held for the sake of expected returns at a future date in the form of interest or dividend. There are various types of financial instruments which vary from each other with respect to their investment features. They are classified into two sub-categories based on term and type.

1) The classification of financial instruments on the basis of term:

a) Short term: A financial instrument is considered to be short-term if its maturity is less than one year.

b) Medium term: A financial instrument is considered to be medium-term if its maturity is more than one year but less than ten years.

c) Long term: If the maturity of the financial instrument is over ten years, then it is said to be a long-term financial instrument.

2) The classification of financial instruments on the basis of type:

a) Primary Securities: If the securities are directly traded by the borrower to the ultimate investor, it is known as primary securities. It includes equity shares, debentures, preference shares, etc.

b) Secondary Securities: These securities are not directly traded by the borrower to the ultimate investor but are issued by the financial intermediaries.

c) New Innovative Financial Instruments: These are financial instruments having new features in terms of agreements, risk, return, maturity, marketability, transaction costs, etc. Some new innovative financial instruments are: Global Depository Receipts, Zero

Coupon Convertible note, Fully Convertible Debentures, Equity Warrants, etc.

Financial services

Efficiency of an emerging financial system essentially depends upon the quality and variety of financial services provided by the financial intermediaries. Financial services refer to the services rendered by the finance industry which includes a wide range of organizations which deal with the financial management. These organizations include banks, insurance companies, credit card companies, consumer finance companies and others.

The different types financial services in India are:

1. Corporate finance: Corporate finance is where the business enterprises arrive at financial decisions and plan the business strategies accordingly.

2. Personal finance: Personal finance, through application of finance principles, helps individuals to make monetary decisions. This helps the individuals or families to obtain, save, budget, and spend monetary resources by taking into consideration the associated financial risks and time period. The personal finance includes savings accounts, credit cards and consumer loans, stock market investments, etc.

3. Public finance: Public finance is an economy related concept and is related with paying for governmental activities. This field educates the economy about the doings of the government with regard to its collections and resources.

Informal financial system in India

This is also known as unorganized financial system and does not come under the supervision of any regulatory bodies. An informal financial system is an unorganized, non-institutional and non-regulated system which deals with the traditional and rural spheres of the economy. This segment includes money lenders, local bankers, traders and loans taken from relatives and friends, etc.

CONCLUSION

A well-developed financial system consists of adequate financial institutions, sufficient financial instruments and properly regulated financial markets. All these factors together provides necessary framework for mobilization and allocation of valuable savings. It is evident that the financial sector in India has seen exceptional growth in the geographical coverage through bank branches, ATMs, financial intermediaries and branchless banking solutions. Many reforms were adopted for removal of a number of institutional barriers to ensure free flow of capital across financial markets.

In India, over a period of past two decades, development of financial sector has resulted into significant increase in the domestic savings rate, particularly savings from household sector. India is one among the few countries to have had consistent growth in domestic savings that has been achieved only because of finance deepening.Gross Domestic Savings have increased substantially higher during past two decades. Thus, this indicates growth in potential funds for capital formation in the country. In conclusion, a developed financial system leads to the economic growth and development of the country. Therefore, there is a positive and direct correlation between the growth in financial system and economic growth and development of a country.

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