Indian Financial System

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PREFACE

The subject matter is written in a simple and easily understandable language with sufficient support from real business world information.

This volume is an attempt to provide the students with thorough understanding of Indian financial system concepts, methods and techniques. We have presented the subject matter in a systematic manner with liberal use of charts and diagrams where ever necessary so as to make it interesting and sustain students interest.

In writing this book we have benefited immensely from the studies of a number of books and the articles written by scholars spread over various books, journals and magazine. We are grateful to them.

We are sure this book will prove extremely useful to students and teachers alike. This book would not have seen the light but for the grace of God and the blessings and support of our family members and friends.

We are quite confident, though, that the book can also be adopted and used successfully. We believe that the book is even suited for self-study. This book will provide an up-to-date first foundation for informed discussion of today's national and global issues.

We offer our gratitude to Himalaya Publishing House Pvt. Ltd., who is leader in Commerce and Management publications. Our sincere regards to Mr. Niraj Pandey, Mr. Vijay Pandey and Mr. N. K. Mitra for interest shown and for the best effort put forth by the matter of publication of this book.

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Any suggestions regarding improvement and errors, if any, will be gratefully acknowledged.

Kolkata **Authors**

Sep., 2018

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FINANCIAL SYSTEM AND ITS COMPONENTS

Unit Overview

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- Objectives of Financial System
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- The Structure of Indian Financial System

INTRODUCTION

Economic growth and development of any nation depends upon a well developed financial system. The term financial system includes financial institution, financial markets, financial instruments and financial services which help in generation of savings leading to capital formation. A good financial system facilitates the transfer of economic resources between different sections of a nation.

A well knit financial system should be characterised by the presence of an organised, specialised, integrated and regulated financial markets, financial institutions, instruments and services that meets both short term and long term financial needs of both household and corporate sector of an economy. Both financial markets and financial institutions play a significant role in the financial system by operating in close combination with each other in order to render various financial services to the needy.

A financial system acts as a link between savers and investors. It helps in mobilization of savings and promotion of investment in an effective manner. The financial system serves as an intermediator between investors and institutions promoting investment leading to greater financial development which is essential for faster economic developments.

Thus, a financial system plays a significant role in the economic growth of a nation by mobilising the surplus finds and channeling the savings into productive activity.

Financial systems facilitate risk-sharing by reducing information and transactions costs. If there are costs associated with the channelling of funds between borrowers and lenders, financial systems can reduce the costs of holding a diversified portfolio of assets. Intermediaries perform this role by taking advantage of economies of scale; markets do so by facilitating the broad offer and trade of assets comprising investors' portfolios.

Financial systems can reduce information and transaction costs that arise from an information asymmetry between borrowers and lenders. In credit markets, an information asymmetry arises because borrowers generally know more about their investment projects than lenders. A borrower may have an entrepreneurial "gut feeling" that cannot be communicated to lenders or more simply, may have information about a looming financial risk to their firm that they may not wish to share with past or potential lenders. An information asymmetry can occur exante or expost. An exante information asymmetry arises when lenders can not differentiate between borrowers with different credit risks before providing a loan and leads to an adverse selection problem. Adverse selection problems arise when lenders are more likely to make a loan to high-risk borrowers, because those who are willing to pay high interest rates will, on average, be worse risks. The information asymmetry problem occurs ex post when only borrowers, but not lenders, can observe actual returns after project completion. This leads to a moral hazard problem. Moral hazard problems arise when borrowers engage in activities that reduce the likelihood of their loan being repaid. They also arise when borrowers take excessive risk because the costs may fall more on lenders compared to the benefits, which can be captured by borrowers.

Meaning of Finance

The word finance is derived from the *Latin word* ***'finis'*** which means money. Finance is an activity by which savings especially bank deposits or currency notes are pooled and then placed in the hands of the investors.

In simple words, finance refers to the management of the flow of money through organisation. Finance is nothing but provision of money as and when required.

Finance also refers to the science that describes the management, creation and study of money, banking, credit, investments, assets and liabilities. Finance consists of financial systems, which include the public, private and government spaces and the study of finance and financial instruments, which can relate to countless assets and liabilities.

Definitions of Finance

According to ***Simon Andrade,*** "Finance is the area of economic activity in which money is the basis of various embodiments, whether stock market investments, real estate, industrial, construction, agricultural development, so on".

According to ***Bodie and Merton,*** "Finance is the study of how scarce resources are allocated over time".

According to ***Ivan Thompson,*** **"**The term finance comes from the Latin "finis" which means end or finish. It is a term whose implications affect both individuals and businesses, organizations and states what it has to do with obtaining and using money or money management".

According to ***O. Ferrel C. and Geoffrey Hirt,*** "The term finance refers to "all activities related to obtaining money and its effective use".

According to ***Henry Ford,*** "Finance or money is an arm or leg which one can either use it or lose it".

FINANCIAL SYSTEM

Financial system is the set of implemented procedures that track the financial activities of a country on a regional scale. The financial system is the system that enables lenders and borrowers to exchange funds. The global financial system is basically a broader regional system that encompasses all financial institutions, borrowers and lenders within the global economy.

A financial system plays a vital role in the economic growth of a country. It intermediates with the flow of funds between those who save a part of their income to those who invest in productive assets. It mobilizes and usefully allocates scarce resources of a country. The formal financial sector is characterized by the presence of an organized, institutional and regulated system which caters to the financial needs of the modern spheres of economy; the informal financial sector is an unorganized, non-institutional and non-regulated system dealing with the traditional and rural spheres of the economy.

A financial system is a complex, well-integrated set of sub-systems of financial institutions, markets, instruments and services which facilitates the transfer and allocation of funds, efficiently and effectively. A high priority should be accorded to the development of an efficient formal financial system as it can offer lower intermediation costs and services to a wide base of savers and entrepreneurs.

The economic scene in the post independence period has seen a sea change; the end result being that the economy has made enormous progress in diverse fields. There has been a quantitative expansion as well as diversification of economic activities. The experiences of the 1980s have led to the conclusion that, to obtain all the benefits of greater reliance on voluntary market-based decision-making, India needs efficient financial system.

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 is the mobilization of savings or their efficient, effective and equitable allocation of investment. It is this success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives. It is this success.

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, specialization in production. 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, savings 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 system. The financial system has been identified as the most catalyzing agent for the growth of an economy, making it one of the key inputs for development.

Meaning of Financial System

Financial system refers to a set of complex and closely connected or inter-linked financial institutions or organised and unorganised financial markets, financial instruments and services which facilitate the transfer of funds.

A financial system consists of institutional arrangements through which financial surplus in the economy are mobilised from units having surplus funds and is transferred to units having financial deficit. Financial system is a total of financial institutions, financial markets, financial services, financial practices and procedures.

Meaning of Financial Dualism

Financial systems of most developing countries are characterized by co-existence and co-operation between the formal and informal financial sectors. This co-existence of two sectors is commonly referred to as “Financial dualism.”

Definition of Financial System

According to ***Robinson,*** "Financial system is the primary function of the system which 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".

According to ***Van Horne,*** "Financial system is the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption".

According to ***Christy,*** "Financial system is to supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilization of resources without the destabilizing consequence of price level changes or unnecessary interference with individual desires".

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 inter temporal smoothing of consumption by households and expenditures by firms and they enable households and firms to share risks. These functions are common to the financial systems of most developed economies. Yet the form of these financial systems varies widely".

According to ***Prof. Prasanna Chandra,*** "The financial system consists of variety of institutions, markets and instruments related in a systematic manner and provide the principal means by which savings are transformed into investments".

OBJECTIVES OF FINANCIAL SYSTEM

The various objectives of financial system are as follows:

1. To mobilise the resources.
2. To create link between savers and investors.
3. To establish a regular smooth and efficient markets.
4. To create assets for the use of people.
5. To encourage savings and investment.
6. To facilitate economic development of the country.
7. To facilitate for expansion of financial markets.
8. To promote for efficient allocation of financial resources.
9. To make sound decisions based on cash flow and available resources.
10. To establish financial control and clear accounting procedures which ensure that funds are used for intended purposes.

SIGNIFICANCE AND ROLE OF FINANCIAL SYSTEM

The financial system of our country plays a very important role in the economic development. The financial system perform a number of functions. Some of the important functions are as follows:

a) ***It ensures effective allocation of resources to different investment channels:*** An effective financial system always enables proper allocation of resources to different investment avenues.

b) ***It plays the role of a catalyst:*** The financial system plays the role of a catalyst by creation of credit and providing finance and credit facilities to different investment opportunities.

c) ***It accelerates the rate of economic development:*** Financial system mobilises the savings and also the investment. By doing so capital formation is achieved which in turn leads to allocating resources to productive activities, which at last leads to the economic development.

d) ***It fosters industrial development:*** It is because of Indian financial system, institutions like IDBI, IFCI, KSFC, ICICI etc. have been developed to foster industrial development. These institutions help industries by providing financial, technical, marketing assistance.

e) ***It is a guide for investors education:*** The financial system play a very important role of providing all necessary investment opportunities to the investors. The financial institutions, banks etc. from time to time publish the necessary investors guide with required details about investments to enlighten the investors.

f) ***It promotes self employment:*** The development banks and financial institutions are primarily established with the objective of promoting self employment. By providing a means of self employment to young educated men and women, it indirectly solves the problem of unemployment.

g) ***It helps in the revival of sick units:*** The financial institutions in our country have specially designed loans schemes to assist the revival of sick units. These loans are provided to sick units at reasonable rate of interest.

h) ***It acts as the mobiliser of savings:*** The financial system mobilises and channelises the small savings to productive activities. In other words, the financial system acts as the transformer of savings into investment.

i) ***It is a provider of liquidity:*** The term liquidity refers to cash or money and other assets which can be converted into cash within a short duration. Almost all the activities of a financial system, are liquidity oriented i.e. there is either provision of liquidity or one can see trading in liquidity.

PURPOSE OF FINANCIAL SYSTEM

The several purposes of financial system are as follows:

a) Financial system is required for mobilisation of savings and converting it into investments.

b) Financial system is essential for providing required capital to the business organisations to carry out their activities.

c) It is required for generating income or profit for both household and corporate sector.

d) It is necessary for increasing the productivity of capital through efficient and effective allocation of funds and resources.

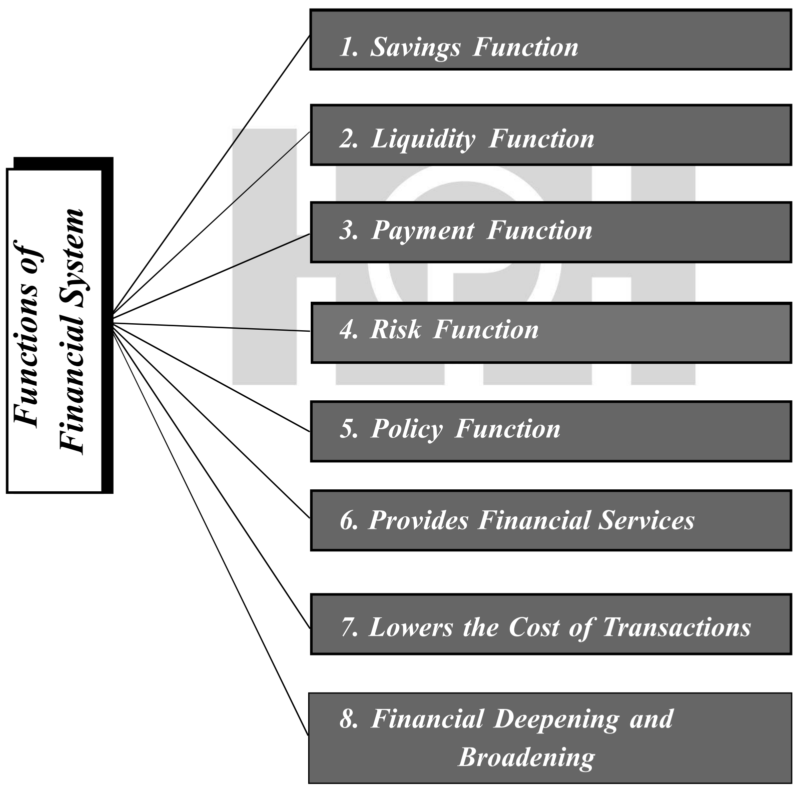
e) It is essential to accelerate the rate of economic growth and development.

f) It is helpful in providing mechanism to control risk and uncertainties in financial transactions.

g) It is required to transfer the resources from one section or part of the economy to another through effective allocation of resources to different investment channels.

FUNCTIONS OF FINANCIAL SYSTEM

A good financial system serves in the following ways:



1. Savings Function

Public savings find their way into the hands of those in production through the financial system. Financial claims are issued in the money and capital markets which promise future income flows. The funds with the producers result in production of goods and services thereby increasing society living standards. This is one of the important functions of a financial system is to link the savers and investors and thereby help in mobilizing and allocating the savings efficiently and effectively. By acting as an efficient conduit for allocation of resources, it permits continuous up-gradation of technologies for promoting growth on a sustained basis.

2. Liquidity Function

The term liquidity refers to ready cash or money and other financial assets which can be converted into cash without loss of value and time. It provides liquidity in the market through which claims against money can be resold by the investors and thereby assets can be converted into cash at any time. This function allows for easy and fast conversion of securities into cash.

Thus, the major function of any financial system is the provision of money and monetary assets for the purpose of production of goods and services. Therefore all the financial activities are subjected to either provision of liquidity or trading in liquidity.

3. Payment Function

The financial system offers a very convenient mode for payment of goods and services. Cheque system, credit card system etc. are the easiest methods of payments. The cost and time of transactions are drastically reduced. A financial system not only helps in selecting projects to be funded but also inspires the operators to monitor the performance of the investment. It provides a payment mechanism for the exchange of goods and services and transfers economic resources through time and across geographic regions and industries.

4. Risk Function

The term risk and uncertainty can be defined as the probability of happening of an unexpected event due to which the investors may be under loss in future.

Whenever the mobilised savings are invested into different productive activities, the investors are exposed to lower risk. This is mainly because of the benefits of 'diversification' that is available to even small investors. Every investor's preference will be influenced by considerations such as convenience, lower risk, liquidity etc.

Financial intermediaries enable the investors to diversify investments widely which helps in reducing the risk of capital depreciation and poor dividends. Hence, a combination of financial assets will help in minimising risk.

5. Policy Function

The government intervenes in the financial system to influence macroeconomic variables like interest rates or inflation. So if country needs more money government would cut rate of interest through various financial instruments and if inflation is high and too much money is available in the system, then government would increase the rate of interest. It makes available price-related information which is a valuable assistance to those who need to take economic and financial decisions.

6. Provides Financial Services

A financial system minimizes situations where the information is an asymmetric and likely to affect motivations among operators or when one party has the information and the other party does not. It provides financial services such as insurance, pension etc. and offers portfolio adjustment facilities.

Example: It provides fee based or advisory based financial services such as issue management, portfolio management, corporate counselling, credit rating, stock broking etc. and fund based or asset based financial services such as hire purchase, equipment leasing, bill discounting, housing finance, insurance service, venture capital etc.

7. Lowers the Cost of Transactions

A financial system helps in the creation of a financial structure that lowers the cost of transactions. This has a beneficial influence on the rate of returns to saver. It also reduces the cost of borrowings. Thus, the system generates an impulse among the people to save more.

8. Financial Deepening and Broadening

A well-functioning financial system helps in promoting the process of financial deepening and broadening. Financial deepening refers to an increase of financial assets as a percentage of the Gross Domestic Product (GDP). Financial broadening refers to building an increasing number variety of different participants and instruments.

Financial broadening begins when corporations seek to employ labor and capital according to their relative contribution to production. It can also influence demand for capital goods (and the labor to create and employ it) which depends on expected consumer demand in a future period. It also includes Profit-maximization which aims to produce more with more productive capital and less labor so that production generally becomes increasingly more capital intensive.

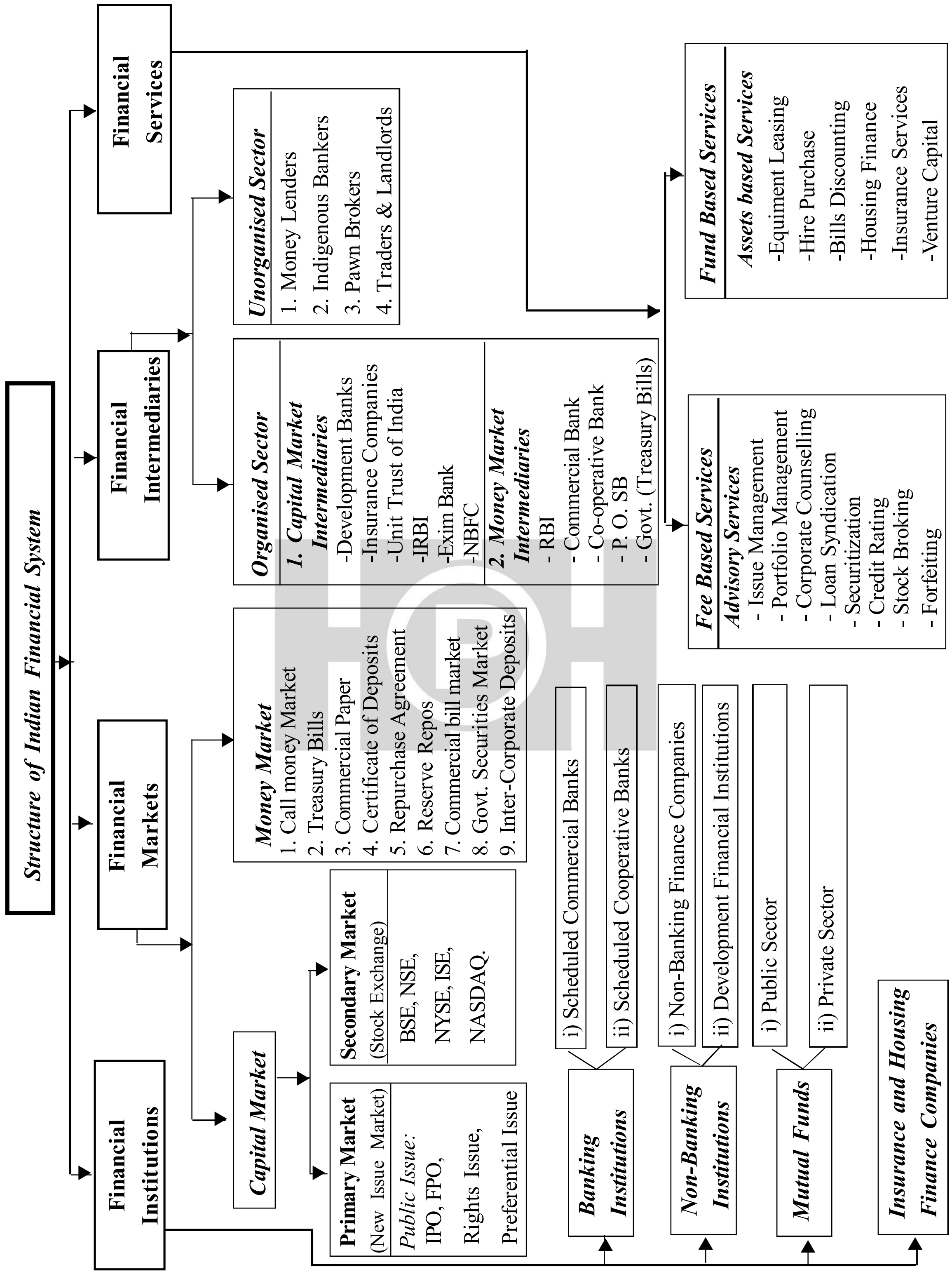
STRUCTURE OF INDIAN FINANCIAL SYSTEM OR COMPONENTS OF FINANCIAL SYSTEM

The following are the four main components of Indian Financial system:

1. Financial Institutions
2. Financial Markets
3. Financial Intermediaries
4. Financial Services

1. Financial Institutions

Financial institutions are the intermediaries which facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return. Financial institutions also provide services to entities seeking advice on various issues ranging from restructuring to diversification plans. They provide whole range of services to the entities who want to raise funds from the markets elsewhere. Financial institutions act as financial intermediaries because they act as middlemen between savers and borrowers, where these financial institutions may be banking or non-banking institutions.



Structure of Indian Financial System
Financial Institutions
Financial Markets
Financial Intermediaries
Financial Services
Capital Market
Primary Market (New Issue Market)
Public Issue:
IPO, FPO,
Rights Issue,
Preferential Issue
Secondary Market (Stock Exchange)
BSE, NSE,
NYSE, ISE,
NASDAQ.
Money Market
1. Call money Market
2. Treasury Bills
3. Commercial Paper
4. Certificate of Deposits
5. Repurchase Agreement
6. Reserve Repos
7. Commercial bill market
8. Govt. Securities Market
9. Inter-Corporate Deposits
Organised Sector
1. Capital Market Intermediaries
-Development Banks
-Insurance Companies
-Unit Trust of India
-IRBI
-Exim Bank
-NBFC
2. Money Market Intermediaries
- RBI
- Commercial Bank
- Co-operative Bank
- P. O. SB
- Govt. (Treasury Bills)
Unorganised Sector
1. Money Lenders
2. Indigenous Bankers
3. Pawn Brokers
4. Traders & Landlords
Fund Based Services
Assets based Services
-Equiment Leasing
-Hire Purchase
-Bills Discounting
-Housing Finance
-Insurance Services
-Venture Capital
Fee Based Services
Advisory Services
- Issue Management
- Portfolio Management
- Corporate Counselling
- Loan Syndication
- Securitization
- Credit Rating
- Stock Broking
- Forfeiting
i) Scheduled Commercial Banks
ii) Scheduled Cooperative Banks
i) Non-Banking Finance Companies
ii) Development Financial Institutions
i) Public Sector
ii) Private Sector
Banking Institutions
Non-Banking Institutions
Mutual Funds
Insurance and Housing Finance Companies

Financial institutions channel the flow of funds between investors and firms. Individuals deposit funds at commercial banks, purchase shares of mutual funds, purchase insurance protection with insurance premiums and contribute to pension plans. All of these financial institutions provide credit to firms by purchasing debt securities or providing loans or other credit products. In addition, all of these financial institutions except commercial banks purchase stocks issued by firms.

Meaning of Financial Institutions

Financial institutions or financial intermediaries are those institutions, which provide financial services and products which customers needs. Financial institutions provide all those services, which a customer may not be able to get more efficiently on his own. *Example:* Customers not having skill to invest in equity market efficiently can invest money in Mutual Funds and can avail the benefits of capital market. Financial institutions provide all those financial services, which are available in financial system.

Benefits of Financial Institutions

The following benefits are enjoyed by an individual who invests through financial intermediaries than involving directly in financial market:

(a) ***Economy of Scale:*** When financial institutions are carrying out their investment or other activities in large scale out of pooled funds, they can achieve economy of scale.

(b) ***Lower Transaction Cost:*** Because of economy of scale the cost of each transaction is much lower than what it would have been, if that transaction is carried on by individual investor on his own.

(c) ***Diversification:*** As financial institutions are dealing in huge amounts of pooled funds, they diversify their investments in such a way that the risk involved would reduce considerably.

2. Financial Markets

A financial market is a market in which people and entities can trade financial securities, commodities and other financial stocks at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds and commodities include precious metals or agricultural goods.

There are both general markets (where many commodities are traded) and specialized markets (where only one commodity is traded). Markets work by placing many interested buyers and sellers, including households, firms and government agencies, in one "place", thus making it easier for them to find each other. An economy which relies primarily on interactions between buyers and sellers to allocate resources is known as a market economy in contrast either to a command economy or to a non-market economy such as a gift economy.

Financial market transactions can be distinguished by whether they involve new or existing securities, whether the transaction of new securities reflects a public offering or a private placement and whether the securities have short-term or long-term maturities. New securities are issued by firms in the primary market and purchased by investors. If investors desire to sell the securities that they have previously purchased, they use the secondary market. The sale of new securities to the general public is referred to as a public offering; the sale of new securities to one investor or a group of investors is referred to as a private placement. Securities with short-term maturities are called money market securities and securities with long-term maturities are called capital market securities

Finance is a prerequisite for modern business and financial institutions play a vital role in an economic system. It is through financial markets the financial system of an economy works. The main objectives of financial markets are:

1. To facilitate creation and allocation of credit and liquidity.
2. To serve as intermediaries for mobilization of savings.
3. To assist process of balanced economic growth.
4. To provide financial convenience.

3. Financial Intermediaries

Financial intermediation consists of "channelling funds between surplus and deficit agents". A financial intermediary is a financial institution that connects surplus and deficit agents. The classic example of a financial intermediary is a bank that consolidates bank deposits and uses the funds to transform them into bank loans.

Financial Intermediaries are the firms that provide services and products which customers may not be able to get more efficiently by themselves in final markets. In other words, they act as middlemen between investors and borrowers in financial system.

Financial intermediaries may be classified into two:

(i) ***Capital market intermediaries:*** Those institutions who provide only long term funds to individual and companies are called capital market intermediaries. *Example:* Financial corporations, Investing institutions etc.

(ii) ***Money market intermediaries:*** Those institutions who provide only short term funds to individuals and corporate customers are called money market intermediaries. *Example:* Commercial banks, Co-operative banks.

Classification of Financial Intermediaries

In general the financial intermediaries in the Indian Financial System are classified in the following ways:

(i) ***Deposit taking organizations:*** These organizations accept deposits from investors and lend the same to various entities. Investors are very familiar with these organizations as they deal with them quite regularly. *Examples:* i) Banks finance companies and ii) National savings organizations.

(ii) Contractual savings organizations: These organizations enter long term contracts with investors. Typically the contract involves receiving a series of periodic payments from investors over a period of time. These companies manage the amount received carefully to adhere to the terms of the agreement and to meet their part of obligations. *Examples:* i) Insurance companies ii) Pension funds.

(iii) Investment type organizations: These companies accept money from investors to manage money for them on their behalf. Normally, it involves making a pool of investor's money and investing it in a portfolio of securities or assets to meet certain common investment objective of the clients. *Example:* Mutual funds.

(iv) Fee based intermediaries: These intermediaries do not become a party to the fund transfer process but just helps in the transfer. They help in providing information to either party about availability of funds or need of funds and help in getting a match. They also help investors in understanding various investment products, understanding risks, analyzing comparative facts and making suitable choices in case of multiple options. They do not take the transactions on their own books.

Functions of Financial Intermediaries

The various functions performed by these intermediaries are broadly classified into two:

Traditional Functions:

(i) Underwriting of investments in shares/debentures etc.

(ii) Dealing in secondary market activities.

(iii) Participating in money market instruments.

(iv) Involving in leasing, hire purchase, venture capital, seed capital etc.

(v) Dealing in foreign exchange market activities.

(vi) Managing the capital issues.

(vii) Making arrangements for the placement of capital and debt instruments with investing institutions.

(viii) Arrangement of funds from financial institutions for the clients' project.

(ix) Assisting in the process of getting all Government and other clearances.

Modern Functions

(i) Rendering project advisory services.

(ii) Planning for mergers and acquisitions and assisting for their smooth execution.

(iii) Guiding corporate customers in capital restructuring.

(iv) Acting as trustees to the debenture holders.

(v) Structuring the financial collaboration through joint venture by identifying suitable partner and preparing joint venture agreement.

(vi) Rehabilitating and reconstructing sick units.

(vii) Hedging of risks by using swaps and derivatives.

(vii) Managing portfolio of large public sector corporations.

(viii) Undertaking risk management services like insurance service, buy back options etc.

(ix) Advising the clients on best source of funding overall.

(x) Guiding the clients in the minimisation of the cost of debt.

(ix) Capital market services such as clearing, registration and transfers, safe custody of securities, collection of income on securities.

(xi) Promoting credit rating agencies.

(xii) Recommending suitable changes in the management structure and management style with a view of achieving better result.

4. Financial Services

Financial services are the economic services provided by the finance industry, which encompasses a broad range of organizations that manage money, including credit unions, banks, credit card companies, insurance companies, consumer finance companies, stock brokerages, investment funds and some government sponsored enterprises.

Efficiency of emerging financial system largely depends upon the quality and variety of financial services provided by financial intermediaries. The term financial services can be defined as "activities, benefits and satisfaction connected with the sale of money that offers to users and customers, financial related value".

Classification of Financial Service

1. Fee based Services

Bank Management sets fees and charges for banking services to ensure that the bank is adequately compensated for the services it provides. When setting fees and charges, Bankers take into consideration the possible exposure to loss, which may be incurred for providing the service, the effort required of the Bank and the amount of time required for performing the service properly.

2. Fund based Services

Fund-based services include cash credit, overdraft, bill discounting, short-term loans and export financing. Fee based facilities include letters of credit and bank guarantees.

CLASSIFICATION OF INDIAN FINANCIAL SYSTEM

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

Classification of Indian Financial System

A. Organised Sectors

1. Regulators
2. Financial Institutions
3. Financial Markets
4. Financial Services

B. Unorganised Sectors

1. Money Lenders
2. Local Bankers
3. Traders
4. Landlords
5. Pawn Brokers
6. Chit Funds

(A) Organized Financial System

1. Regulators

Market Regulator is a body appointed under an act of Parliament to regulate one or several markets to ensure integrity. In India, we have specific authorities to regulate each sector to prevent overlapping.

The main sectors are banking, securities, insurance and pension. In India, we have the following Regulators:

i) Reserve Bank of India (RBI)

ii) Securities and Exchange Board of India (SEBI)

iii) Ministry of Finance

iv) Ministry of Corporate Affairs

v) Insurance Regulatory Authority of India (IRAI)

vi) Pension Fund Regulatory and Development Authority (PFRDA)

2. Financial Institutions

Financial Institution is an establishment that focuses on dealing with financial transactions, such as investments, loans and deposits. Conventionally, financial institutions are composed of organizations such as banks, trust companies, insurance companies and investment dealers. Almost everyone has to deal with a financial institution on a regular basis. Everything from depositing money to taking loans and exchanging currencies must be done through financial institutions.

Indian Financial Institutions are as follows:

i) Credit Rating Information Services of India Limited (CRISIL)

ii) Investment Information and Credit Rating Agency of India (ICRA India)

iii) Insurance Regulatory and Development Authority of India (IRDAI)

iv) Board for Industrial and Financial Reconstruction (BIFR)

v) Export Import Bank of India (EXIM)

vi) National Bank for Agricultural and Rural Development (NABARD)

vii) Small Industries Development Bank of India (SIDBI)

viii) National Housing Bank (NHB)

3. Financial Markets

A financial market is a market in which people and entities can trade financial securities, commodities and other financial stock at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds and commodities include precious metals or agricultural goods.

There are both general markets and specialized markets. Markets work by placing many interested buyers and sellers, including households, firms and government agencies, in one "place", thus making it easier for them to find each other. An economy which relies primarily on interactions between buyers and sellers to allocate resources is known as a market economy in contrast either to a command economy or to a non-market economy such as a gift economy.

4. Financial Services

Financial services are the economic services provided by the finance industry, which encompasses a broad range of organizations that manage money, including credit unions, banks, credit card companies, insurance companies, consumer finance companies, stock brokerages, investment funds and some government sponsored enterprises. Financial services refer to services provided by the finance industry. The finance industry encompasses a broad range of organizations that deal with the management of money.

(B) Unorganized Financial System

1. Money lenders

A moneylender is a person or group who offers small personal loans at high rates of interest. The Register of Money Lenders required to be maintained under section 4 shall be in Form 1. Display of the list of licensed money lenders. Every Assistant Registrar shall display on a notice board in his office a list of money lenders licensed to carry on the business of money lending in the area under his jurisdiction. Such list shall contain the addresses of the money lenders.

2. Local Bankers

Local banker is a person who conducts the business of banking; one who, individually, or as a member of a company, keeps an establishment for the deposit or loan of money, or for traffic in money, bills of exchange, etc.

3. Traders

A trader is person or entity, in finance, who buys and sells financial instruments such as stocks, bonds, commodities and derivatives, in the capacity of agent, hedger, arbitraguer and speculator.

Traders are either professionals or institutions working in a financial institution or a corporation or individual retail. They buy and sell financial instruments traded in the stock markets, derivatives markets and commodity markets, comprising the stock exchanges, derivatives exchanges and the commodities exchanges. Several categories and designations for diverse kinds of traders are found in finance, these may include:

- Day trader
- Floor trader
- High-frequency trader
- Pattern day trader
- Rogue trader
- Stock trader

4. Landlords

A landlord is the owner of a house, apartment, condominium, land or real estate which is rented or leased to an individual or business, who is called a tenant. When a juristic person is in this position, the term landlord is used. Other terms include lessor and owner.

5. Pawn Brokers

A pawnbroker is an individual or business that offers secured loans to people, with items of personal property used as collateral. The word pawn is derived from the Latin word 'pignus', for pledge and the items having been pawned to the broker are themselves called pledges or pawns or simply the collateral.

If an item is pawned for a loan, within a certain contractual period of time the pawner may purchase it back for the amount of the loan plus some agreed-upon amount for interest. The amount of time and rate of interest, is governed by law or by the pawnbroker's policies. If the loan is not paid (or extended, if applicable) within the time period, the pawned item will be offered for sale by the pawnbroker. Unlike other lenders, the pawnbroker does not report the defaulted loan on the customer's credit report, since the pawnbroker has physical possession of the item and may recoup the loan value through outright sale of the item. The pawnbroker also sells items that have been sold outright to them by customers.

6. Chit Funds

A Chit fund is a kind of savings scheme practiced in India. A Chit fund company means a company managing, conducting or supervising, as foremen, agent or in any other capacity, chits as defined in Section 2 of the Chit Funds Act, 1982. According to Section 2(b) of the Chit Fund

Act, 1982, "Chit means a transaction whether called chit, chit fund, chitty, kuri or by any other name by or under which a person enters into an agreement with a specified member of persons where every one of them shall subscribe a certain sum of money (or a certain quantity of grain instead) by way of periodical installments over a definite period and that each such subscriber shall, in his turn, as determined by lot or by auction or by tender or in such other manner as may be specified in the chit agreement, be entitled to the prize amount".

Such chit fund schemes may be conducted by organized financial institutions or may be unorganized schemes conducted between friends or relatives. There are also variations of chits where the savings are done for a specific purpose. Chit funds also played an important role in the financial development of people of south Indian state of Kerala, by providing easier access to credit. In Kerala, chitty (chit fund) is a common phenomenon practiced by all sections of the society. A company named Kerala State Financial Enterprise exists under the Kerala State Government, whose main business activity is the chitty. Chit Funds are also misused by its promoters and there are many instances of the founders running what is basically a Ponzi scheme and absconding with their money.

MULTIPLE CHOICE QUESTIONS (MCQ)

1. What is the meaning of "financing" in the financial market?
   [a] Advising an organization to raise charity funds
   [b] Investing in the securities market
   [c] Sourcing funds
   [d] Converting the assets into cash
2. Financial instrument such as commercial paper can be sold
   [a] issued by commercial banks [b] directly
   [c] with brokers or dealers [d] functional buyers
3. Type of instrument whoever holds it, gets interest and principal amount is classified as
   [a] term instrument [b] interim instrument
   [c] primary instrument [d] bearer instrument
4. Negotiable deposit certificate are traded in
   [a] secondary markets [b] primary markets
   [c] direct markets [d] indirect markets
5. In primary markets, property of shares which made it easy to sell newly issued security is considered as
   [a] increased liquidity [b] decreased liquidity
   [c] money flow [d] large funds

6. India is a member of the International Monetary Fund since _____.
   [a] 1934 [b] 1935 [c] 1947 [d] 1949
7. Markets in which derivatives are traded, are classified as
   [a] assets backed market
   [b] cash flow backed markets
   [c] mortgage backed markets
   [d] derivative securities markets
8. Transaction cost of trading of financial instruments in centralized market is classified as
   [a] flexible costs
   [b] low transaction costs
   [c] high transaction costs
   [d] constant costs
9. Type of market in which securities with less than one year maturity are traded, is classified as
   [a] money market
   [b] capital market
   [c] transaction market
   [d] global market
10. Financial instruments of public markets include
   [a] transfer funds [b] bearer bonds [c] shares [d] bonds
11. The market which deals in trade bills, promissory notes and government papers or bills, which are drawn for short-periods is called
   [a] Money market
   [b] Capital market
   [c] Primary market
   [d] Secondary market
12. A financial market in which short-term papers or bills are brought and sold is known as
   [a] Bill market [b] Commercial market [c] Capital market [d] Call market
13. In order to protect the interests of investors and regulate the working of stock exchanges, the Government in 1988 set up the
   [a] SEBI
   [b] SIDBI
   [c] RBI
   [d] Bank of India
14. The financial market for long-term funds is known as
   [a] Capital market
   [b] Money market
   [c] Primary market
   [d] Secondary market
15. Finance Function comprises
   [a] Safe custody of funds only
   [b] Expenditure of funds only
   [c] Both a and b
   [d] Procurement and effective use of funds
16. The objective of wealth maximization takes into account
   [a] Amount of returns expected
   [b] Timing of anticipated returns

[c] Risk associated with uncertainty of returns

[d] All the above

17. Financial management mainly focuses on

[a] Efficient management of every business

[b] Brand dimension

[c] Both a and b

[d] All elements of acquiring and using means of financial resources for financial activities

18. When the market's required rate of return for a particular bond is much less than its coupon rate, the bond is selling at

[a] Premium [b] Discount

[c] Face value [d] None of these

19. If an investor may have to sell a bond prior to maturity and interest rates have risen since the bond was purchased, the investor is exposed to

[a] The coupon effect [b] The interest rate

[c] At maturity [d] None of these

20. Interest rates and bond prices

[a] Move in the same direction [b] Move in opposite direction

[c] Have no relationship with each other [d] All the above

21. Development financial institutions include ______________.

[a] State financial institutions [b] Central financial institution

[c] State and financial institution [d] All of the above

22. The unorganized financial system includes ______________.

[a] Commercial banks [b] Merchant banks

[c] Indigenous banks [d] All of the above

23. Development financial institutions have been established to cater to ___________ of the industrial sector.

[a] Short-term financial needs [b] Medium-term financial needs

[c] Long-term financial needs [d] All of the above

24. The ultimate source of money in India is ______________.

[a] Commercial banks [b] Indian companies

[c] RBI [d] All the above

25. Long-term debt instruments have a maturity of ______________.

[a] One year [b] Over one year

[c] One and half year [d] None of these

26. The organized financial system includes _____________.
    [a] Commercial banks [b] Indigenous banks
    [c] Foreign banks [d] None of these
27. The unorganized financial system comprises of _____________.
    [a] Money lenders [b] Indigenous bankers
    [c] Lending pawnbrokers [d] All the above
28. The lender of the last resort to the market is the _____________.
    [a] Commercial banks [b] Indigenous banks
    [c] Money lenders [d] RBI

Answer:

1.	[c]	2.	[b]	3.	[d]	4.	[a]	5.	[a]
6.	[c]	7.	[d]	8.	[b]	9.	[a]	10.	[c]
11.	[a]	12.	[a]	13.	[a]	14.	[a]	15.	[d]
16.	[d]	17.	[d]	18.	[a]	19.	[b]	20.	[b]
21.	[a]	22.	[c]	23.	[c]	24.	[c]	25.	[b]
26.	[a]	27.	[d]	28.	[d]				

REVIEW QUESTIONS

Short Type Questions

1. What is a financial system?
2. What do you mean by "financial dualism"?
3. Give the meaning of term financial intermediaries.
4. Define financial markets.
5. What is financial services?

Long Type Questions

1. Discuss the significance and role of financial system.
2. What are the objectives of financial system?
3. Explain the purpose of financial system.
4. Discuss the functions of financial system.
5. Explain the constituents of financial system.
6. Explain the components/structure of Indian financial system.

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