Indian Financial Systems

I. Introduction to Financial Systems

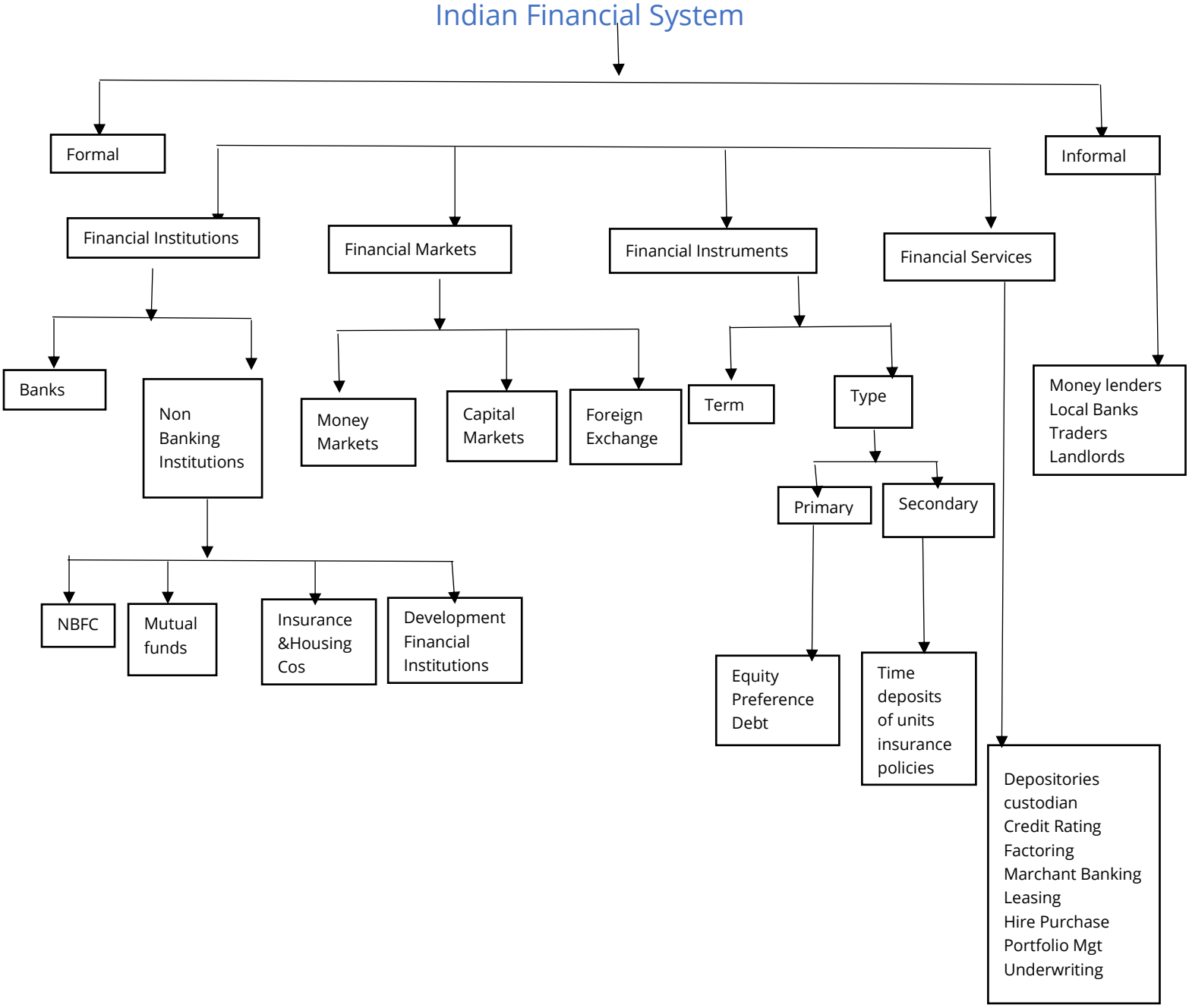
Financial system includes financial market, financial institutions, financial services and financial instrument which influence the generation of savings, investment, capital formation and growth.

The primary function of the financial system is the mobilization of savings, their effective utilization for investment in various sectors of the economy and stimulating capital formation to accelerate the process of economic growth. Thus, the financial system has been identified as the most refurbishing factor for growth of the economy, making it one of the important inputs for development.

II. Significance of Financial System

a. Leads to savings – which meets the fund requirements of the business through financial market.
b. Enables investments to commence production of goods and services.
c. Leads to capital formation that ultimately brings economic growth.

Indian Financial System



III. Types of Financials System

A. **Informal Financial System:** These people have a system and they have their own rules on how they should function in their day to day activities. Eg: moneylenders; Associations, funds, clubs, committees etc. It is faster, no interest rate regulation.

B. **Formal Financial System**: The formal financial system consists of financial institutions, financial markets, financial instrument, and financial services.

(i) Financial Institutions: Financial Institutions can be classified as banking and non-banking financial institutions. Banks are creators and providers of credit. While non-banking financial companies are only providers of credit.

- **Banking Financial Institutions**: Banking institutions are those institutions, which participate in the country's payment system, i.e. they provide transaction services. They play an important role in the mobilization of deposits and distribution of credit to various sectors of the economy.

- **Non-Banking Financial Institutions:** Non-banking financial institutions are those institutions which act as mere providers of credit and they do not create credit, e.g., LIC, UTI, and IDBI.

Comparison between Banking and Non-Banking Financial Institutions:

Basic for comparison	Banking Institutions	Non-Banking Institutions
Meaning	Bank is a financial intermediary which provides banking services with holding license	Non- banking institutions provides banking services without holding banking license
Credit creation	Banks create credit.	Non-banking institutions do not create credit
Demand Deposits	Not accepted	accepted
Transaction services	Provide transaction services Eg: Over draft facility, Issue of Cheques Etc.	Not provide any transaction services
Money supply	Bank deposits is major part of the national money supply	The money supply of the nonbanking institutions is small
Payment and settlement systems	Contains an integral part of the system	Not a part of the system

(ii) **Financial Markets:** The financial market is a market where trading of securities including equities, bonds, currencies and derivatives takes place. Financial market can be divided into money market and capital market. Money market is a market for short term securities having a maturity period of less than one year. Capital Market is a market for long term securities having a maturity period of more than one year. Further, capital market can be divided into primary market and secondary market. In primary market, securities (shares, bonds, debentures) are issued to the public for the first time. While in secondary market, trading (purchase and sale) takes place in those securities are already issued to the public.

Functions of Financial Markets:

1. To facilitate creation and allocation of credit and liquidity.
2. To serve as intermediaries for mobilization of savings.
3. To help in the process of balanced economic growth.
4. To provide financial convenience.
5. To provide information and facilitate transactions at low cost.
6. To cater to the various credits needs of the business organizations.

(iii) Financial Instruments: Financial instruments are those instruments which have a monetary value. These instruments can be classified into debt based securities and equity based securities. Equity based securities consist of equity share capital which is ownership based securities and represents risk capital. Debt based securities consists of bonds and debentures.

Characteristics of Financial Instruments:

1) **Liquidity:** Financial Instruments can be easily and quickly converted into cash.
2) **Marketing:** It facilitates easy trading on the market as they always have a ready market.
3) **Collateral Value**: It can be pledged for getting loans.
4) Transferability: Financial Instruments can be transferred from one person to another.
5) **Maturity period:** It may be Short-term, Medium-term or Long-term.
6) **Transaction cost:** Financial Instruments involve buying and selling costs which are called as transaction costs.
7) **Risk:** Equity based instruments are riskier in comparison to debt based instruments because the payment of dividend is uncertain. A company may not declare dividend in a particular year. However, payment of principle or interest is more or less certain unless the company gets insolvent.
8) **Future trading:** Financial instruments facilitate future trading so as to cover risks arising out of price fluctuations, interest rate fluctuations etc.

(iv) Financial Services: Financial services are services which involves investment, lending, and management of money and assets. Financial services are needed for the following activities:

(i) Borrowing and lending

(ii) Investing

(iii) Buying and selling securities

(iv) Making and enabling payments and settlements

(v) Managing risk