Indian Financial System

As per new B Com CBCS syllabus 2017 for CU

SECOND EDITION

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Oxford University Press is a department of the University of Oxford.
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Oxford University Press in the UK and in certain other countries.

Published in India by
Oxford University Press
Ground Floor, 2/11, Ansari Road, Daryaganj, New Delhi 110002, India

First Edition published in 2017
Second Edition published in 2018

ISBN-13: 978-0-19-948934-3
ISBN-10: 0-19-948934-3

Typeset in Baskerville MT STD
by E-Edit Infotech Private Limited (Santype), Chennai
Printed in India by Magic International (P) Ltd., Greater Noida

Cover image: Alfazet Chronicles / Shutterstock

Dedicated to

My childhood and teenage memories—

with Dipra Bhattacharya, Ritwick Ray, Rajarsi Ray, Sreejata Ghosh,

Srijit Mitra, Sudipta Bhattacharyya, and Amit Ray

Preface

Financial system is closely interlinked with economic development. Basically economic development indicates both qualitative and quantitative aspects. Economists and financial experts relentlessly try to determine the impact of the changes in the financial indicators on economic activities. Some serious efforts have been made to assess the impact of financial activities on capital formation and economic development. The various theoretical and empirical findings are suggestive of significant effects of financial indicators on economic development. However, these financial indicators are not the only ones to affect economic growth. Actually they have a considerable amount of influence over the factors of economic development. Thus it is often believed that a strong and sound financial system acts as a catalyst to economic development. It enhances the standard of living of the people as well as ensures the well-being of the population.

One important aspect of the financial system is its capability to encourage the rate of savings and investment in the economy. An ideal and efficient financial system has the capability of filling the gap between investment and savings potential of the economy and thereby, mobilizing the savings. The specialty of the financial system is that it not only initiates investment but also directs the investible fund into the productive sectors of the economy. This definitely leads to greater possibilities of economic development. On the other hand, the economic development of a nation increases the efficiency of the financial system. Thus we observe some sort of complementarity between a financial system and economic development.

India is one of the emerging developing nations which is expected to be a superpower in the near future. The recent development in the nation owes significantly to the financial sector reforms since 1991, when the country adopted the strategy of liberalization, privatization, and globalization. Naturally the robust growth of the economy is a matter of interest among the economists and financial experts. The second edition of the book *Indian Financial System* comprises various financial aspects of Indian economy and presents a detailed idea about the operations in the financial market. The Indian financial system is now going through a phase of alterations and introduction of new techniques, rules, and regulations. This is a part of the strategy of turning the Indian financial system compatible with the financial systems of the developed nations. The financial sector reforms are going to change the financial habits of the population. The government puts emphasis on the digitalization of the financial transactions. A combination of all these changes and the existing traditional modes make the Indian financial system an interesting one. This has motivated me to write a book on the Indian financial system in a lucid manner so that it is easily comprehensible to the students.

ABOUT THE BOOK

This book is mainly designed for the students of 3rd semester (2nd year) B Com Honours under CBCS system, University of Calcutta. Apart from this, the book will also be useful for the students pursuing commerce course in graduation and postgraduation in other universities. The students of professional courses will also find the necessary materials and inputs from the book which will meet their requirements. Above all, the young researchers in this field can gather the basic and preliminary ideas and information from this book.

The objective of the book is to make the readers aware of the various aspects of the Indian financial system and financial market operations. The book provides theoretical knowledge of the components of the financial system with appropriate examples. As an author I have made an effort to provide the readers what are not available in the existing books. Besides, I have tried to explain the contents of the chapters in a lucid manner for the benefit of the students. Thus we are hopeful that this book will not merely be an addition to the already existing corpus in this field, but will also be able to create a unique and separate identity due to its special features.

The key features of the book are as follows:

- The book clearly mentions the learning objectives at the beginning of the chapters which will enable the students to be focused.
- The chapters are written in a simple lucid style so that the students can independently extract the matters for their use.
- The contents are prepared with the objective of providing conceptual understanding and logical explanations to the students.
- One of the most important features of the book is the simple diagrammatic representation of most of the subject matter through figures and flow charts.
- Current and latest data are incorporated in the subject matter for better understanding of the trends of various macroeconomic indicators.
- Some topics are accompanied by graphical representation so that the students can grasp the subject matter conveniently.
- All chapters are followed by exercises with essay type, short, and multiple choice questions which are very much relevant these days.
- The detailed summary and glossary at the end of every chapter will help the students in a quick understanding of the contents and subject matter.
- The important and extremely relevant portions of the subject matter are highlighted so that the students can focus on them.
- The book also comprises solved CU question papers of the last four years and two model questions which will benefit the students immensely.
- After the completion of the chapters, a separate section of question bank has been introduced which comprises over forty five solved questions, collected from different university examinations. This will provide guidance to the students on how to construct the answers to the questions.

CONTENTS AND CHAPTERS

This book is comprised of five chapters which present the Indian financial system in a detailed approach.

Chapter 1 deals with the basics of the financial system and its components. It mainly focuses on the activities of financial intermediaries and also provides description about the structure of Indian financial system and its recent changes.

Chapter 2 has two parts. Part A, discussing money market, provides a fair idea about money and central banking. It focuses on the features and functions of money market, types of money market instruments in India, and the money market reforms after liberalization. Call money market is also discussed in detail.

Part B provides a detailed analysis of the features, functions, divisions, instruments, and participants of capital market. The chapter clearly distinguishes the features of primary and secondary market and also discusses every aspect of the stock exchange. The chapter also focuses on the recent changes in the capital market.

Chapter 3 comprises details of different types of financial institutions including the structure and functions of a commercial bank along with the process of credit creation. Following this, it focuses on the functions and monetary policies of Reserve Bank of India (RBI) and the recent changes in the monetary policy. The chapter also describes the functions of development financial institutions like NABARD, SIDBI, and EXIM Bank, insurance organizations like LICI and GICI, and mutual funds and NBFCs.

Chapter 4 explains financial services in detail. In this chapter, merchant banks and credit rating agencies are analysed. It also provides detailed view of the objectives and activities of merchant banks and credit rating agencies.

Chapter 5 discusses the protection measures for investors and provides remedies to investors' grievances. It also assesses the role of SEBI, court, and media in protecting the interest of the investors.

ACKNOWLEDGEMENTS

I have received active support and motivation from a number of persons for writing this book. My parents Mr Lakshmikanta Bhattacharjee and Mrs Alaka Bhattacharjee have always been there to inspire me throughout this long journey. I am grateful to my teachers who taught me the basics of the subject. The support I have received from Aishee and Writi, my elder brother Mr Dipra Bhattacharya, my sister-in-law Mrs Rina Bhattacharya, and my in-laws Mr Manab Basu Mallik and Mrs Shikha Basu Mallik is fabulous. My wife Prof. Debashree Bhattacharya has not only helped me focus on the writing by sharing the entire burden at home singlehanded but also rendered assistance to prepare the content. My student Prof. Sucharita Bhattacharyya of Barasat College has actively participated in preparing study material by investing her time and hard work affectionately. My ex-student Prof. Soumya Mukherjee of Maharaja Manindrachandra College and my student Subhadeep Chanda of Heramba Chandra College have also helped me in different publication-related matters.

I am also indebted to my supervisors Prof. Arup Mitra of Institute of Economic Growth, New Delhi, and Dr Asim Karmakar, my Principal Dr Shyamal Kumar Chakraborty, and Prof. Sidhdhartha Majumdar of City College for continuous guidance and advice. Prof. Biswajit Chatterjee of Jadavpur University, Prof. Santanu Ghosh of Maulana Azad College, and Dr Indrani Saha of Sri Sikhshayatan College have always encouraged me to pursue this sort of work. My teacher and mentor Mr Indrajit Das inspired me a lot in completing the assignment. My colleagues of Maharaja Srischandra College are as usual cooperative and I should name Prof. Soma Sengupta, Dr Sonali Banerjee, Debjani Kundu, Anindita Bhattacharyya, Debasis Mukherjee, Prabir Dutta, Pradip Mukherjee, Prembahadur Manjhi, Bidyut Sarkar, Tilok Naskar, Dr Asim Das, Dr Avijit Chakraborty, Ayan Chatterjee, Dr Bijoy Rawani, Dr Debasree De, Zeba Jahan, Sara Basu, Sarita Mal, and Amrita Kundu for their tremendous support. The teachers of the Department of Commerce—Arup Kr Bhattacharya, Dr Supti Kotal, Krishnapada Dash, Shreya Basu, Debjani Kundu, and Camellia Sarkar have also motivated me a lot during this project. Prof. Supriya Bhattacharyya has provided relevant advice and inputs in constructing the subject matter. Nabarun Bhattacharyya, Kuntal Mitra, Neeraj Gupta, and Dr Soumyabrata Roychaudhuri were always present with their extended hands of cooperation, technical support, and motivation throughout the journey. Prof. Debjani Lahiri and Dr Sunanda Ray of our college and Mita Dutta, the educator at Dakshineswar Sri Sri Sarada Devi Balika Vidyamandir have also rendered their assistance in preparing the course material.

My heartfelt thanks and gratitude to those friends who helped me, choosing to remain invisible themselves.

I am also extremely grateful to the editorial and sales teams of Oxford University Press for their patience and inspiration which boosted me to complete the project finally.

Feedback and suggestions for improving the future editions are always welcome and can be sent to me at sujatra_bh@rediffmail.com.

Sujatra Bhattacharyya

Features of

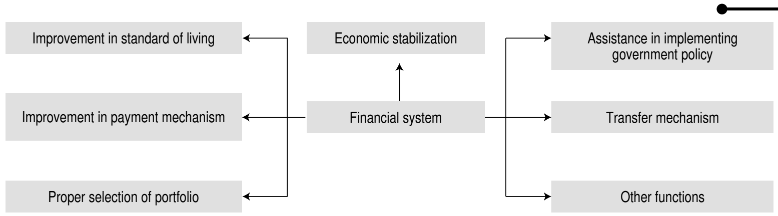

Fig. 1.6 Functions of a financial system

Figures The chapters contain numerous well-labelled figures and flowcharts to enhance the assimilation of the topics.

Tables The chapters contain numerous detailed tables to support the text.

Table 1.2 Differences between financial intermediary and non-financial intermediaries

Basis of Difference	Financial Intermediary	Non-financial Intermediary
Nature	They raise funds from the public and provide credit to industry, trade, and commerce	They directly invest in industry, trade, and commerce
Collection of funds	They collect funds from small savers and investors	They directly invest in the industries, and, hence, there is no question of raising the funds
Deposit mobilization	They help in deposit mobilization by collecting deposits and channelize them to investors	They do not accept deposits from the public
Variety of services	They generally provide short-, medium-, and long-term finances to the industries	Apart from financial assistance, they provide technical and advisory services

GLOSSARY

Banking intermediaries directly participate in the payment mechanism and various transactions. They together can create money or credit.
Capital market is that part of financial market, which deals with the long-term claims and, like money market, ensures the flow of funds from surplus to deficit units.
Direct finance refers to a financial system where savings are directly channelized into investments through the financial market without any intervention of financial intermediaries such as insurance organizations, mutual funds, and other financial institutions.
Fee-based services refer to the specialized services provided by some professionally managed institutions against requisite fees. These services mainly imply technical and financial advices.
Finance is referred to be the mainstay of the economy as it is adequately required to perform various economic activities such as development of infrastructure, creation of employment opportunities, economic development, and establishment of industries.
Financial institutions refer to the institutions that act as intermediaries in the transfer of funds from surplus to deficit units and, thus, mobilize savings in the economy.
Financial instruments or assets, which are heterogeneous in nature, refer to the legal claims associated with a future cash flow.
Financial intermediaries refer to institutions that facilitate the process of transfer of fund from fund providers to fund seekers and, thus, mobilize the savings.
Financial market refers to a centre that provides the facilities of sale and purchase of financial claims and services.
Financial non-intermediaries do not work as a medium between fund providers and fund seekers. They do not accept any deposit from the general public. They actively take part in the business and sometimes invest in the proper sector
Financial regulators refer to institutions that generally try to protect the interest of the investors and maintain the financial discipline of the market.

Glossary Every chapter contains a glossary of key words with definitions to recapitulate important terms.

the Book

Solved CU QPs and Model QPs
The book contains solutions to last four years' university question papers, as well as two model question papers for students to get a feel of examinations.

Solved Question Papers

INDIAN FINANCIAL SYSTEM (2018)

1.

Ans.

Model Question Papers

SET-1

Group-A

1.	Discuss the importance of financial intermediary in the financial system.	5
OR	Distinguish between banking and non-banking financial intermediary.	5
2.	What are the functions of NABARD/SIDBI/EXIM banks in Indian financial market?	5
OR	State the functions of NBFCs in Indian financial system.	5
3.	Distinguish between life insurance and general insurance.	5
4.	Briefly explain the structure of Indian financial system.	5

Question Bank

Chapter 1 Financial System and Its Components

1. Define financial system. What is the significance of the financial system?

A financial system is an integral part of the economy. It plays a pivotal role in the overall economic growth of a nation. We can define financial system as a combination of various complex and mutually interdependent financial activities that also acts as connecting link between savers and investors to fulfil a certain and predetermined objective. The financial system acts as an intermediary, which ensures the flow of funds from surplus to deficit units. The financial system performs its basic activities through the components and involves

Question Bank
The book contains a question bank of solved model questions to help the students prepare for examinations.

MULTIPLE CHOICE QUESTIONS

1. A financial system ensures the flow of funds from
   (a) Investors to savers
   (b) Savers to investors
   (c) Investors to government
   (d) G...
2. Wh...
   reg...
   (a)
   (c)
3. Wh...
   Nar...
   (a)
   (b)
   (c)
   (d)
4. In which of the following eras, the Indian financial system was characterized by a lack of financial innovation?
   (a) Post-liberalization phase
   (b) In the mid-1960s

MCQs and Exercises
Each chapter contains a set of MCQs and review questions for self-evaluation.

EXERCISES

Short Answer Type Questions **5 Marks**

1. Explain the role of finance briefly.
2. Show how the funds flow from surplus to deficit units through a financial system.
3. What are the components of a financial system?
4. What are the functions of financial services institutions in a financial system?
5. How do the financial instruments help in the smooth functioning of the financial system?
6. Distinguish between the financial intermediary and financial non-intermediary.
7. Define financial institutions. What are the functions of the financial institutions?

Essay Type Questions **10 Marks**

1. Define a financial system. Mention its significance and functions.
7. Discuss the different types of finance in a financial system.
8. Discuss the organizational structure of the Indian financial

Contents

Road Map to Indian Financial System

Unit	Topic	Details	Chapter
Unit I	Financial System and Its Components	Meaning, Significance, and Role of the Financial System; Components of the Financial System; The Structure of Indian Financial System	1
Unit II	Financial Markets	A. Money Market: Functions and Instruments; Role of Central Bank; Indian Money Market: An Overview, Call Money Market, Treasury Bills Market, Commercial Paper (CP) Market, Certificate of Deposit (CD) Market; Concepts—Repo, Reverse Repo; Recent Trends in the Indian Money Market	2A
		B. Capital Market: Functions and Instruments; Primary and Secondary Markets—Functions and Inter-relationship, Methods of New Issues; Indian Debt Market and Equity Market; Market Intermediaries—Brokers, Sub-brokers; Role of Stock Exchanges in India; Recent Trends in the Indian Capital Market	2B
Unit III	Financial Institutions	Commercial Banking: Functions of Commercial Banks, Credit Creation by Commercial Banks and its Limitations; Reserve Bank of India: Functions, Credit Control and Monetary Policy; Development Financial Institutions in India: NABARD, EXIM Bank, SIDBI; Life Insurance and General Insurance Companies in India: Functions; Mutual Funds: Concept of Mutual Fund, Types of Mutual Funds (Open Ended and Close Ended); Role of Mutual Funds in Indian Capital Market; Non-banking Financial Companies (NBFCs): Definition, Functions, Regulations of RBI over NBFCs	3
Unit IV	Financial Services	Merchant Banks: Functions and Role, SEBI Regulations; Credit Rating: Objectives and Limitations, SEBI Regulations; Credit Rating Institutions and their Functions	4
Unit V	Investors' Protection	Concept of Investors' Protection; Grievances Regarding New Issue Market and Stock Exchange Transactions, and the Grievance Redressal Mechanism; Role of SEBI, Judiciary and the Media	5

CHAPTER

1 Financial System and Its Components

Syllabus Mapping	Chapter
Unit I: Financial System and Its Components Meaning, Significance, and Role of the Financial System; Components of the Financial System; The Structure of Indian Financial System	1

Learning Objectives

After studying this chapter, you should be able to

- understand the meaning of finance, financial system, financial institutions, financial markets, financial services, financial instruments, and financial regulators
- realize the importance of financial intermediary, financial regulators, and financial system
- know the difference between banking and non-banking intermediary, fund-based and fee-based financial services, and organized and unorganized financial market
- get an idea about the various types of finance
- learn the components of a financial system
- know the structure of the Indian financial system in the pre-independence, pre-liberalization and post-liberalization period
- understand the organizational structure of the Indian financial system and financial sector reforms

1.1 FINANCE

Finance is often termed as the life blood of the industry. In an economic system, it is practically indispensible. Finance is acknowledged to be the mainstay of the economy as it is adequately required to perform various economic activities such as development of infrastructure, creation of employment opportunities, economic development, and establishment of industries.

'Finance' is sometimes referred to as money or liquid assets. In this context, finance is essential for the purchase of goods and services. It also assists in making profits in the future through investment. We highlight the role of finance in a modern economic system further.

1.1.1 Role of Finance

1. **Purchase of goods and services** As mentioned earlier, finance in the form of money is required to purchase goods and services in an economy. An individual or an organization has to purchase goods and services for a smooth functioning. Money enables them to buy goods and services.
2. **Life blood of industry** Industrial development is totally dependent on finance. As blood is essential for the smooth functioning of a human body, similarly, industries cannot survive without finance. The industry-based commercial activities cannot be performed without finance.

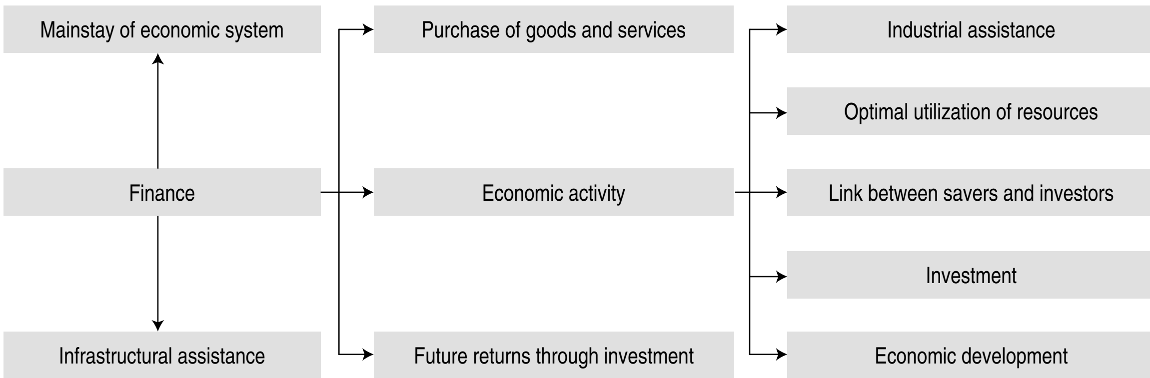

Fig. 1.1 Role of finance

3. **Optimal utilization of resources** In a country, extraction of natural resources and their optimal utilization is extremely necessary for development. In this context, finance plays a major role. Owing to scarcity of finance, the natural resources cannot be optimally extracted and utilized.
4. **Link between savers and investors** Finance connects savers and investors in an economy. People save their income after expenditure. These savings can then be transformed into investments or finance through proper channelization.
5. **Investment** Finance sometimes clearly means investment. Investments are made to reap future profits and returns. Proper investment leads to capital formation and economic development.
6. **Capital formation** Savings of the household sector is the prime source of finance, which when directed to proper and desired channels of the economy, results in the rise of productivity. Mobilizations of savings in the form of deposits ensure the capital formation in the economy.
7. **Economic development** The economic development of a nation hugely depends on the developments in agricultural and industrial sectors. Besides, trade, commerce, and other economic activities should be performed judiciously. Finance ensures the development of agricultural and industrial sectors of the country and a smooth functioning of trade and commerce. According to Van Horne, finance is nothing but the spirit of trade, industry, and commerce. All these are responsible for the economic development of a country (Fig. 1.1).

1.2 FINANCIAL SYSTEM

Financial system is one of the most important facets of the modern society. It ensures the flow of funds from surplus to the deficit units to restore the proper balance of the economy. However, before stepping into the domain of financial system, we should first concentrate on the meaning of a 'system'.

When a set of mutually interdependent units perform to fulfil a certain objective, we call it a system. In other words, when the activities of some closely interlinked units are properly coordinated, it generates a system (Fig. 1.2).

Accordingly, we can define a financial system on the basis of two different viewpoints.

1. **Macroeconomic view** In every system, some mutually interlinked units together work for fulfilling an objective. On the whole, a financial system refers to the combination of some economic and financial

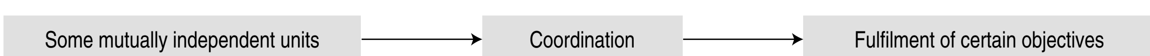

Fig. 1.2 The system

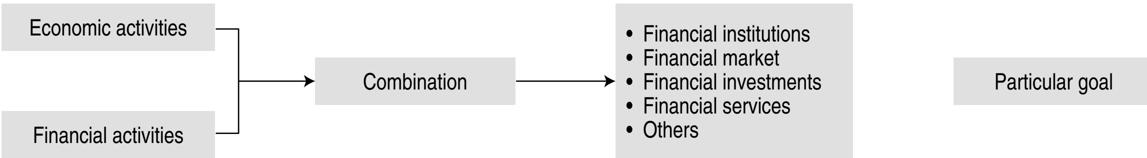

Fig. 1.3 Macroeconomic view of a financial system

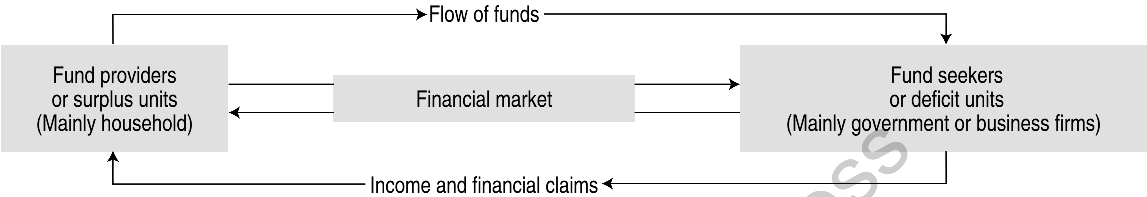

Fig. 1.4 Coordinative view of a financial system

activities that has the objective of achieving a particular goal through its components, namely, financial institutions, markets, instruments, services, and other relevant issues (Fig. 1.3).

2. **Coordinative view** From this viewpoint, a financial system acts as an intermediary between surplus and deficit units of the economy. Thus, a financial system ensures the flow of funds from fund providers to fund seekers. According to Robinson, one of the main activities of the financial system is 'to provide link between savings and investment for the creation of new wealth'. We know an economy cannot flourish without adequate funds. Financial system provides and channelizes the funds from savers to investors in an efficient manner through its components.
   We can summarize the facts through Fig. 1.4.

> Hence, a financial system is a combination of various complex and mutually interdependent financial activities, which also acts as a connecting link between savers and investors to fulfil a certain and predetermined objective.

1.2.1 Role or Significance of the Financial System

A financial system performs its basic activities through the components. It involves the macro variables of the economy to satisfy its objectives. Accordingly, it has an enormous impact over the different sectors of the economy.

The following are considered to be the implications of a financial system.

1. **Mobilization of savings** A financial system ensures the flow of funds from surplus to deficit units of the economy and, in this way, acts as an intermediary between savers and investors. An efficient financial system properly channelizes the funds into desired directions, which is responsible for faster mobilization of savings.
2. **Capital formation** Capital is one of the most important factors of production that has the ability to assimilate the other factors of production. Now, capital formation is one of the main pre-conditions of economic development. An efficient and sound financial system focuses on the capital formation.
3. **Escalation in investment** Investment is defined as the addition to the stock of capital. A sound and efficient financial system helps in capital formation that leads to a rise in the investment in the economy. It channelizes the available funds to the productive sectors of the economy and, thus, transforms the savings into investments. Moreover, a financial system provides right signal regarding the choice between long-term social benefits and short-term returns.

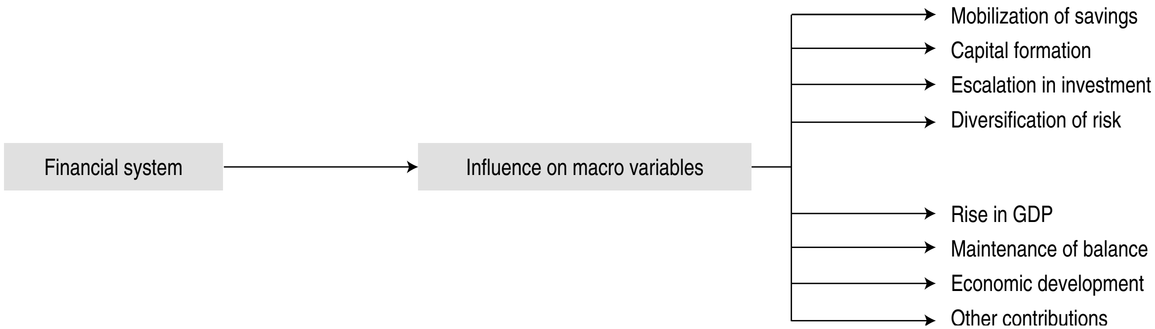

Fig. 1.5 Significance of a financial system

4. **Diversification of risk** A financial asset often involves both risk and return. An appropriate financial system assists the investors to select the best possible one from the various assets available. In this context it also provides the opportunities of diversification to reduce the risk.
5. **Rise in the gross domestic product (GDP)** GDP can be increased if the available resources in the economy are optimally utilized and adequate funds are directed to the productive sectors. A properly managed financial system ensures proper channelization of funds and optimal utilization of the resources. This leads to a stable and sustained rise in the GDP.
6. **Maintenance of balance** As mentioned earlier, the financial system acts as an intermediary between surplus and deficit units. So, naturally, it is able to fill the disparities between the supply of savings and investment demand. This makes the economy healthier.
7. **Economic development** A financial system, if perfectly operative, can help in the process of economic development. A sound financial system is conducive of capital formation if there is a continuous flow of funds from savers to investors. Proper capital formation and the resulting investment lead to economic development.
8. **Other contributions**
   (i) A financial system comprises *financial institutions such as banks and insurance organizations*, which combine the different financial markets. They provide finance to the fund seekers, collected from the savers. Some financial institutions also provide technical and financial assistance to the sick and small industrial units.
   (ii) A financial system comprises the *financial services institutions* that provide the facilities of a modern and transparent exchange and transaction mechanism.
   (iii) A financial system includes *insurance organizations* that introduce various social security schemes for the public.

Thus, we can evidently observe the contribution and role of the financial system in the aforementioned discussion. The significance of the system can be summarized through Fig. 1.5.

1.2.2 Functions of a Financial System

A financial system is the mainstay of an economic development. A proper and well-managed financial system contributes immensely in the process of economic development. As the financial system involves the macro variables of the economy, the existence of the financial system is felt in the economy.

We can identify the following as functions of the financial system.

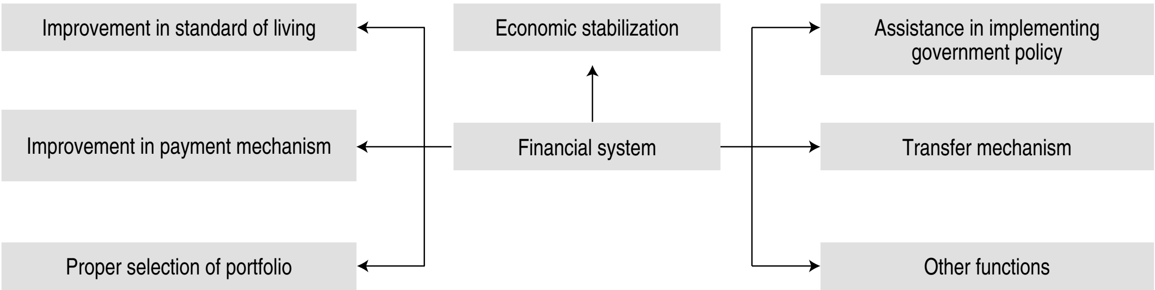

Fig. 1.6 Functions of a financial system

1. **Improvement in the standard of living** A perfect financial system directs the funds from the savers to the investors. It channelizes the savings of the household sector into the productive sectors of the economy. This fund is responsible for developed goods and services in the economy, which in turn upgrade the standard of living of the people.
2. **Economic stabilization** Economic stabilization is essential for the development of the nation. A proper and well-managed financial system helps to maintain the stability of the economy. Government of a nation adopts fiscal and monetary policy for economic stabilization. These policies are implemented through different constituents of the financial system.
3. **Assistance in implementing government policy** In a capitalistic economy, market plays the pivotal role, whereas in the mixed economies apart from market, government also intervene in certain issues. For instance, to control inflationary consequences, government uses various financial instruments and tools such as bank rate and variable reserve ratio, which also influence the necessary macro variables. Thus, a financial system plays a major role to implement the objectives of the government.
4. **Improvement in the payment mechanism** A strong and developed payment mechanism can ease the process of development of a country. However, the standard of the payment mechanism is entirely dependent on the efficacy of the financial system. An efficient financial system is favourable to the sound and compact payment mechanism, which reduces both the time and cost of various transactions.
5. **Transfer mechanism** A well-organized financial system helps in smoothening of the process of transfer of funds from the supplier to the demander. It should be worth mentioning that, without this transfer mechanism, an economy cannot develop. The financial system through its components helps in the transfer mechanism.
6. **Proper selection of portfolio** A person's portfolio consists of both risky and risk-free assets. Cash is the major liquid asset that is risk-free, but owing to inflation, the value of cash starts to diminish. Hence, a person always tries to mix the risky and risk-free assets in his portfolio optimally. A financial system is composed of some specialized financial institutions that provide advices to a person regarding the combination of risky and risk-free assets in the portfolio.
7. **Other functions** A financial system performs widely varied activities that are mentioned earlier in this section. The other notable functions are
   (i) Future is unknown to all of the individuals. The financial system comprises *insurance companies* that reduce or eliminate the risks associated with life, assets, health, etc.
   (ii) An investor can always convert his/her assets into liquid cash in the *financial market*. The existence of the financial system provides him/her the opportunity to do so.

The activities of the financial system can be better understood from Fig. 1.6.

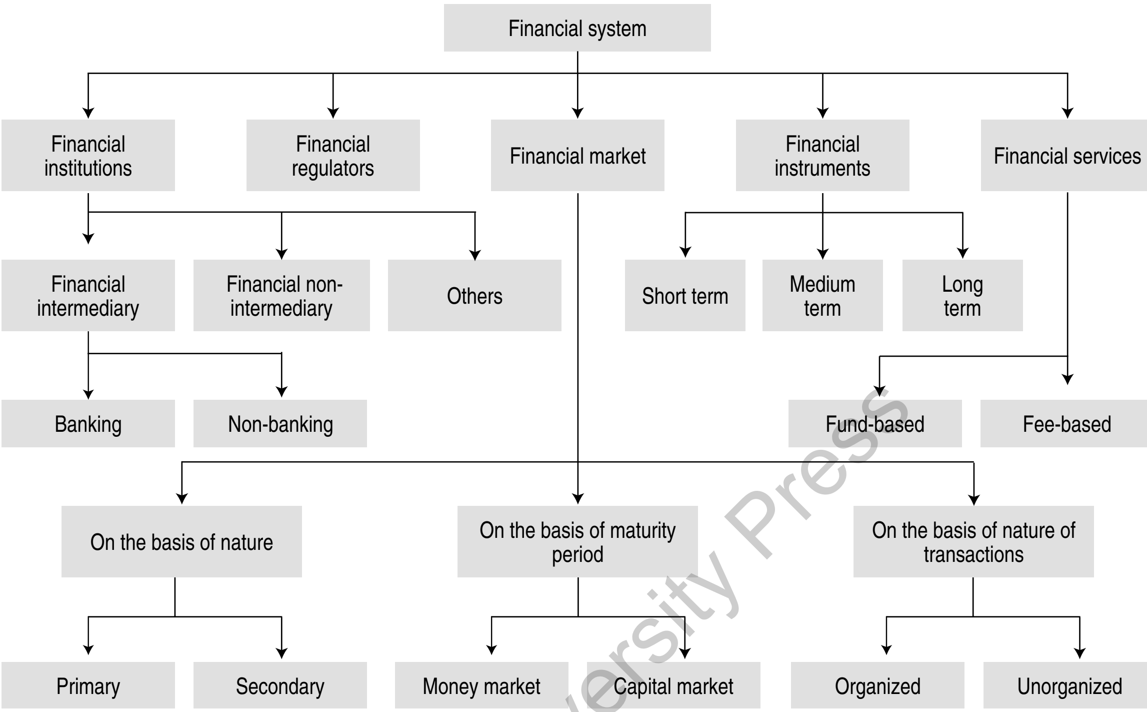

Fig. 1.7 Components of a financial system

1.2.3 Components of a Financial System

A financial system includes various mutually interrelated financial issues and different policies and customs of the financial market. Thus, the financial system has to perform a combination of varied activities. In this context, we can identify the following as the components of the financial system (Fig. 1.7):

(i) Financial institutions
(ii) Financial markets
(iii) Financial instruments
(iv) Financial services
(v) Financial regulators

1.2.3.1 Financial institutions

Financial institutions are regarded as an integral part of the financial system. They mobilize savings on one hand and work as a supplier of credit on the other hand. Financial institutions refer to the institutions that act as intermediaries in the transfer of funds from surplus to deficit units and, thus, mobilize savings in the economy.

We shall discuss financial institutions and their classifications here. In most cases, we observe more or less similar functions by the financial institutions. However, we can classify the financial institutions on the basis of primary functions and degree of specialization.

a) ***Financial intermediary***

Financial intermediaries play a vital role in strengthening the financial system. It refers to such institutions that facilitate the process of transfer of fund from fund providers to fund seekers and, thus, mobilize the savings.

Financial intermediaries are extremely important for the smooth functioning of a financial system. Their existence in the financial system is mainly due to the market imperfections. However, we can understand their importance from the following issues:

- Financial intermediaries can be classified into banking and non-banking intermediaries. The banking intermediaries keep the savings of the people and provide interest income to the depositors against the deposit. Hence, the general public have a lot of faith in the banking system, which is quite important for the development of banking as well as the financial system.
- Financial non-banking intermediaries also play their part in the financial system. For instance, the insurance organizations also play their role as financial intermediary and reduce the risk associated with a person's life, assets, health, etc. They collect their premium annually but they have to pay the compensation only if there is an accident, death, loss of assets, etc. Thus, non-banking intermediaries are also very important for the general public.
- A person always tries to mix the risky and risk-free assets optimally in his portfolio. However, this is not an easy task, because this requires knowledge and experience. A normal person, in this case, consults with the financial experts of the financial intermediaries and then takes the right decision.

Thus, the reasons for the existence of the financial intermediaries or their importance can be easily understood from the aforementioned analysis.

1. **Classification of the financial intermediaries** We can divide the financial intermediaries into two distinct components on the basis of the activities and structure (see Table 1.1).
   a) ***Banking intermediary*** Banking intermediaries are the main component of the organized money market. They accept deposit from the public and provide interest income to the depositors against the deposit. Banking intermediaries directly participate in the payment mechanism and various transactions. They together can create money or credit. Hence Prof. Sayers termed them as 'creators of credit'. Apart from this, the notable functions of the banks are provision of credit, acting as a representative of the clients, implementation of social and economic objectives, etc. The banking institutions also make investment for long-term purposes. These intermediaries assist in developing foreign trade by smoothing the foreign exchange transactions. For instance, State Bank of India (SBI).
   b) ***Non-banking intermediary*** The non-banking intermediaries cannot be treated as banks, though they exhibit similarities with the banking institutions. They collect term deposits from the public and

Table 1.1 Differences between banking and non-banking intermediaries

Basis of Differences	Banking Intermediary	Non-banking Intermediary
Nature of deposit	Three types—savings, demand, and fixed deposits	Generally fixed and term deposits
Credit creation	They can create credit	They are purveyors of credit
Operational area	They mainly operate in the money market	They mainly operate in the capital market
Nature of loans	They mainly provide short- and medium-term loans to the borrower	They provide medium- and long-term loans to the trade, industry, and commerce
Sector	They are mainly concerned with organized sector	Their presence is felt in both organized and unorganized sectors
Control	Their activities can be controlled by the monetary authority like central bank	They cannot be controlled by the credit policy of the central bank
Withdrawal	Depositors can withdraw their deposit before maturity date	Depositors cannot withdraw their money till their maturity in most of the cases
Example	State Bank of India	General Insurance Corporation of India

provide medium- and long-term credits to the industrial units. They cannot create credit, and Sayers termed them as 'purveyors of credit'. They play an important role in the creation of new financial assets and in the reduction of risk. Apart from this, these institutions play an active role in developing capital market. The non-banking financial intermediaries promote infrastructural facilities and assist in the process of rapid industrialization. Sometimes, these institutions also take the responsibility of underwriting when a company issues new shares in the primary market. For example, Life Insurance Corporation of India (LICI) is treated as a non-banking intermediary.

2. **Role/functions of the financial intermediaries**

a) ***Mobilization of savings*** Financial intermediaries ensure the flow of funds from savers to investors. They channelize the funds to the desired direction so that the productive capacity of the economy can rise. Thus, the financial intermediaries mobilize savings and create the path for investment.

b) ***Capital formation*** The banking financial intermediaries provide short-term loans while the non-banking financial intermediaries provide medium- and long-term loans. These funds are utilized in the production of goods and services. Thus, financial intermediaries are one of the main sources of capital formation.

c) ***Optimal utilization of resources*** The financial intermediaries employ professionally efficient and competent persons. These qualified professionals take prudent and effective decisions regarding investment of funds. This in turn ensures the optimal utilization of the resources.

d) ***Investment*** Without financial intermediaries, it is impossible to mobilize savings, leaving no scope for investment. Financial intermediaries generate funds for investment from the savers. This leads to capital formation and economic development.

e) ***Liquidity*** Financial intermediaries try to maintain liquidity in the financial system. Investors always prefer liquidity, and financial intermediaries utilize the accumulated funds in such an efficient manner so that the invested fund can be liquidated whenever required. Thus, investors feel free to invest an adequate amount of money.

f) ***Advisory function*** Financial intermediaries, through their experienced and knowledgeable employees, provide advice to the investors. Moreover, they are aware of the market conditions, performance of the companies, and investment potential. This helps the investors to opt for the right decision.

g) ***Banking services*** Financial intermediaries include banking services, which become the most important function of the intermediary. The banks accept deposit from the public, provide credit, provide advices to their clients, etc.

h) ***Non-banking services*** Non-banking institutions are also treated as integral part of the financial intermediaries. These institutions are involved in various activities such as reduction in risk, creation of new assets, and economic development. For instance, a lot of people keep their faith on insurance organizations as they reduce the risk associated with their life or asset.

i) ***Economic development*** As the financial intermediaries ensure the flow of funds from surplus to deficit units, the resources are effectively mobilized. This leads to optimal utilization of resources and capital formation. Financial intermediaries try to increase the rate of capital formation, which is conducive to economic development (Fig. 1.8).

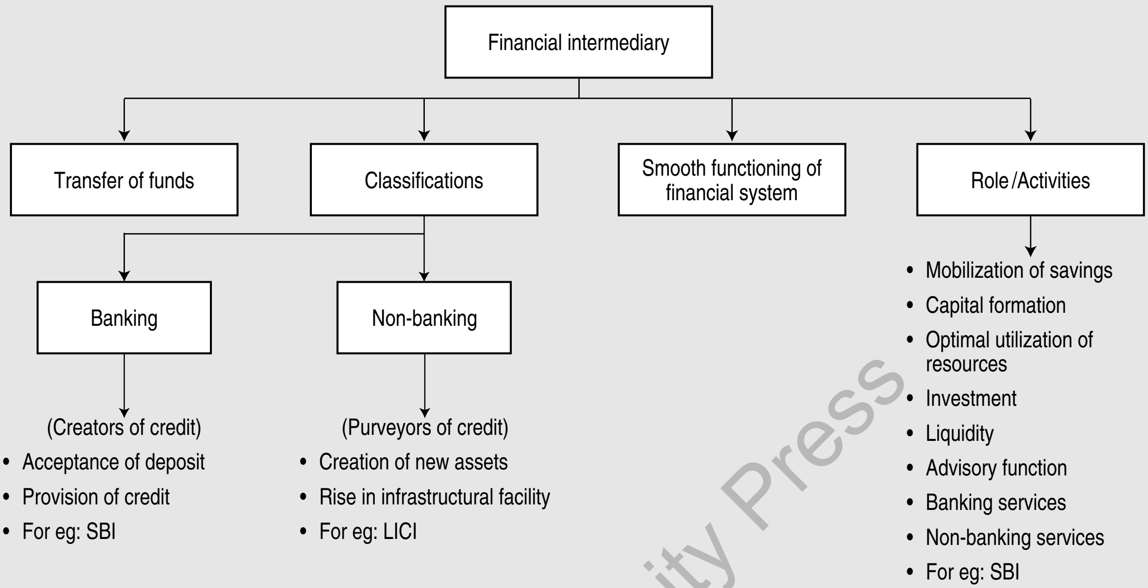

Fig. 1.8 Financial intermediary

Table 1.2 Differences between financial intermediary and non-financial intermediaries

Basis of Difference	Financial Intermediary	Non-financial Intermediary
Nature	They raise funds from the public and provide credit to industry, trade, and commerce	They directly invest in industry, trade, and commerce
Collection of funds	They collect funds from small savers and investors	They directly invest in the industries, and, hence, there is no question of raising the funds
Deposit mobilization	They help in deposit mobilization by collecting deposits and channelize them to investors	They do not accept deposits from the public
Variety of services	They generally provide short-, medium-, and long-term finances to the industries	Apart from financial assistance, they provide technical and advisory services
Medium	They act as a medium between savers and investors	They do not act as a medium
Example	State Bank of India, LIC of India	Industrial Finance Corporation of India

b) ***Financial non-intermediary*** Financial non-intermediaries do not work as a medium between fund providers and fund seekers. They do not accept any deposit from the general public. They actively take part in the business and sometimes invest in the proper sector. Industrial Finance Corporation of India (IFCI) is treated as an example of financial non-intermediary (see Table 1.2). The major activities of the financial non-intermediaries are outlined further.

- They invest directly in the shares and debentures of corporate companies.
- These institutions assist in the process of industrial and economic development.
- They provide long-term loans to the industries for different purposes.
- They provide technical consultations to the trade, commerce, and industry.
- In case of formulating new project, these non-intermediaries play a vital role.

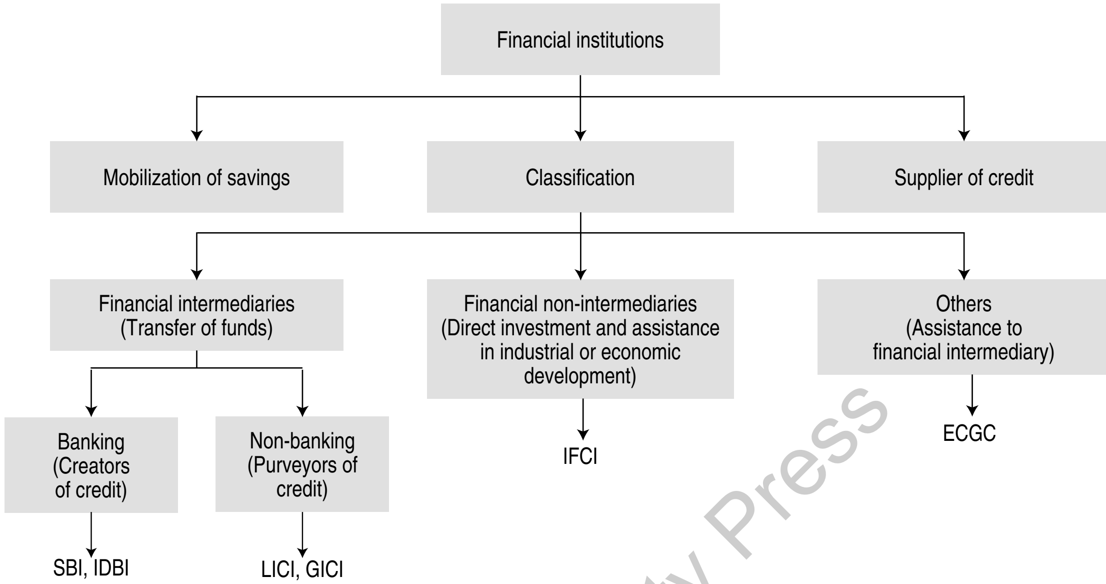

Fig. 1.9 Financial institutions

c) ***Other financial institutions*** These financial institutions neither act as a medium none are involved in direct investment. They are mainly constituted to help different financial intermediaries. These institutions are also very important as they work actively to expand the business and create the right atmosphere for the business to grow. Export Credit Guarantee Corporation of India (ECGC) can be regarded as an example of other financial institutions (Fig. 1.9).

1.2.3.2 Financial markets

Financial market refers to a centre that provides the facilities of sale and purchase of financial claims and services. The individuals, financial institutions, corporations, and government trade in this market either directly or indirectly through brokers and dealers.

The players in this market are borrowers, lenders, agents, dealers, brokers, savers, etc.

The financial markets can be classified as follows:

1. **On the basis of the nature of securities** On the basis of the nature of the securities, financial market can be divided into primary market and secondary market (details in Chapter 8).
   a) ***Primary market*** The financial market that deals with new financial claims or securities is known as a primary market. As this part of financial market deals with new securities, it is also known as 'new issue market'. Primary market supplies additional capital to the industrial and business concerns.
   b) ***Secondary market*** The financial market that deals with the already existing securities is known as secondary market. Thus, in the secondary market, the existing securities are sold and purchased. The secondary market does not play any role directly in supplying additional capital but can provide liquidity to the old or existing securities.
2. **On the basis of the period/tenure of maturity** On the basis of the nature of the period/tenure of maturity, the financial market can be divided into money market and capital market. (Details are given in Chapters 7 and 8 of the Financial Market operations part.)

a) ***Money market*** The financial market that deals with short-term securities and claims (with a period of maturity of one year or less) is known as money market. This market is extremely significant in the sense that, through this market, equilibrium is restored removing deficit and providing surplus of short-term funds. Apart from this, the money market supplies working capital to the industry and commerce. Treasury and commercial bill market, call money market, certificate of deposit market are the examples of money market. In India, Reserve Bank of India (RBI) plays a vital regulatory role in the money market.

b) ***Capital market*** The financial market that deals with the long-term claims and, like money market, ensures the flow of funds from surplus to deficit units is known as capital market. This market provides long-term finance (with a period of maturity of more than one year) to the trade, industry, and commerce. Insurance companies, investment trust, and various public and private organizations are the main credit providers in this market. Stock market and government bonds market are the examples of capital market. In India, Security and Exchange Board of India (SEBI) plays the major regulatory role in the capital market.

3. **On the basis of nature of transactions** On the basis of nature of transactions, the financial market can be classified into organized and unorganized financial markets (see Table 1.3).

a) ***Organized market*** The organized market can be defined as that part of financial market, where the transactions occur according to the specific rules and regulations. There is a close interlink between the different units of this market. The participants in this market are controlled by some regulatory authority. Naturally, this market involves formal transactions. Call money market and insurance markets are the examples of the organized financial market.

b) ***Unorganized market*** The part of financial market where the transactions occur without any well-defined structure and rules is known as unorganized financial market. There is no coordination between the different units of this market. There is no controlling authority in this market, and, hence, most of the transactions in this market are informal. Credit market of rural moneylenders is an example of an unorganized financial market (Fig. 1.10).

Table 1.3 Differences between organized and unorganized financial markets

Basis of Difference	Organized Financial Market	Unorganized Financial Market
Nature of transactions	The transactions take place according to the market norms.	The transaction takes place without any market norms.
Participants	The participants are central bank, commercial banks, and developmental institutions.	The participants are moneylenders, indigenous bankers, chit funds, etc.
Interest rate	In this market, the rate of interest is market determined and comparatively low.	In this market, the interest rate is generally high.
Coordination	The coordination among various units of the market is strong.	There is no coordination between the various units of the market.
Control	This market is regulated by the central monetary authority.	This market is beyond the control of the monetary authority.
Registration	The participants are generally registered under statutory organizations.	The participants here are not registered.
Volume of transactions	In this market, voluminous transactions take place due to confidence of the people.	In this market, lesser amount of transactions occur due to lack of transparency.
Economic development	This market has a positive role in ensuring economic development.	The presence of this market hinders economic development.
Example	Organized money market.	Rural moneylender's credit market.

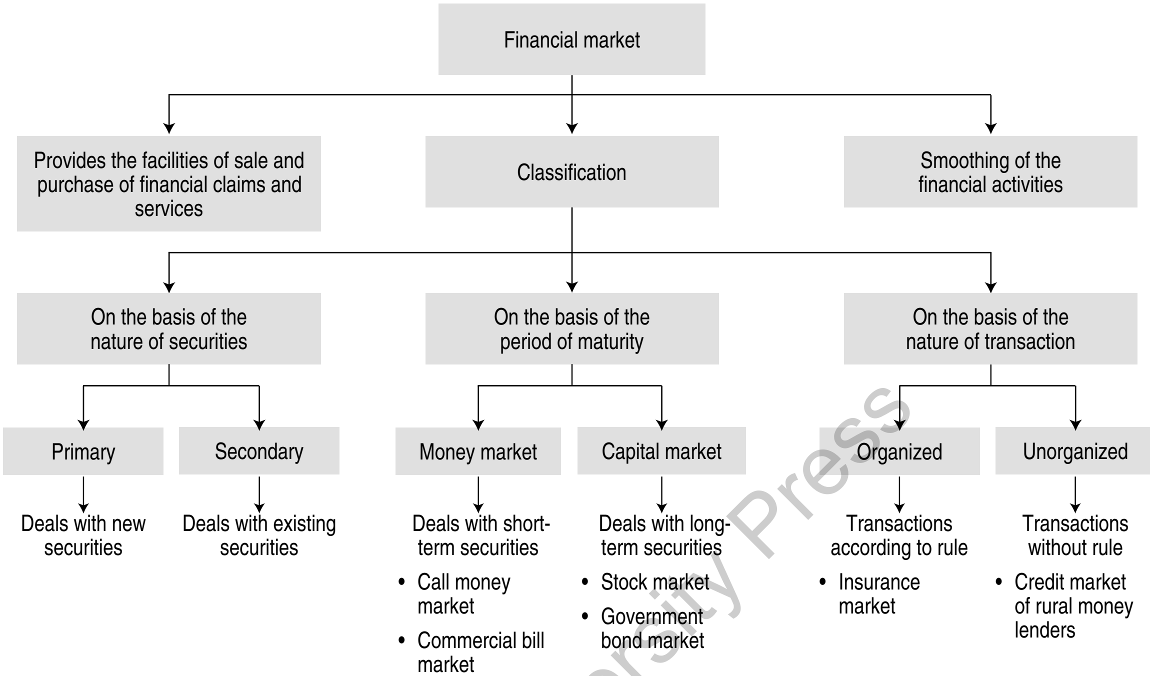

Fig. 1.10 Financial markets

1.2.3.3 Financial instruments

Financial instruments are one of the principal components of the financial system.

> Financial instruments or assets, which are heterogeneous in nature, refer to the legal claims associated with a future cash flow. The financial instruments play a major role in mobilizing the financial market.

The examples of financial instruments are treasury bills, equity shares government bonds, fixed deposit receipts, and commercial papers.

The purpose of borrowing and lending differs for each individual. Hence, we observe distinct variations in these financial instruments. The variations in the nature and feature of investment are responsible for the heterogeneity of the financial instruments. Thus, financial instruments differ from one another on the basis of maturity period, transferability, reversibility, degree of uncertainty, liquidity, transaction costs, and marketability. Generally, financial institutions, government, and companies issue financial instruments to create new capitals.

On the basis of the maturity, financial instruments can be classified under the following heads:

1. **Short-term financial instruments** The short term instruments refer to those financial assets that can be redeemed by the investor or repaid by the issuing institutions with a fixed interest to the investor within a short period of time (less than one year). These instruments are mainly associated with money market and can be converted to cash quickly. Fixed deposits for less than one year and 164-day treasury bill are the examples of short-term financial instruments.
2. **Medium-term financial instruments** The medium-term instruments refer to those financial assets that can be redeemed by the investor or repaid or returned by the issuing institutions with fixed

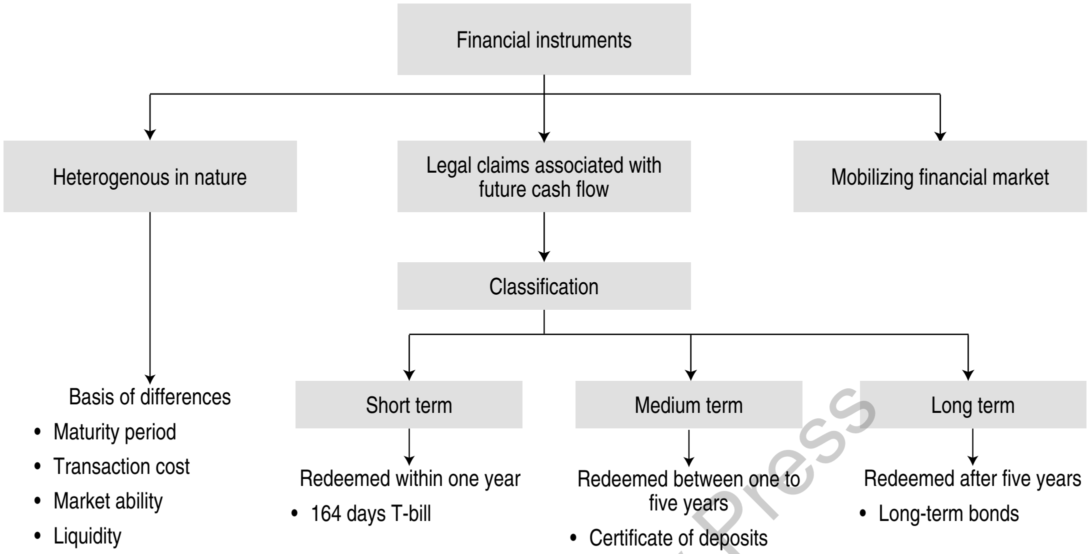

Fig. 1.11 Financial instruments

interest to the investor within a period of one to five years. Certificate of deposits and different types of term bonds are the examples medium-term financial instruments.

3. **Long-term financial instruments** The long-term instruments refer to those financial assets that can be redeemed by the investor or repaid or returned by the issuing institutions with a fixed interest to the investor after the completion of at least five years. Investors can get dividends or high rate of interest from these assets. The examples of long-term financial assets are equity shares, long-term bonds, and debentures (Fig. 1.11).

1.2.3.4 Financial services

Financial services are financial institutions that provide various fund-based and advisory services to the business and industrial units. Thus, financial services are very important in the context of smooth functioning of the financial system.

Financial services mainly comprise advisory services and financial aid, which are the basic requirements of the business institutions or concerns. Financial assistance is purely tangible in nature, but advisory services are purely intangible. Advisory services are given by financial experts who are experienced and knowledgeable. These experts adjust themselves in accordance with the changing business environment. Thus, the financial services have to conduct research works that help them to assimilate the new innovations and business strategies. Naturally, the requirement of the firms differs, and, hence, the financial services provide specific and customized services to their clients. Thus, financial services render various need-based services to their clients.

1. **Types of financial services** We can categorize the financial services under the following heads (see Table 1.4):

   a) ***Fund-based financial services***

Fund-based financial institutions refer to institutions that assist other organizations by reducing risk and providing capital.

Table 1.4 Differences between fund-based financial services and fee-based financial services

Basis of Difference	Fund-based Services	Fee-based Services
Nature	They provide funds to the business units to meet their requirements	They provide advisory services to their clients and charge fees against their services
Risk	These institutions provide funds and reduce risks	They only provide advisory services
Objective	The main objective is the provision of capital	Their main objective is provision of various technical, financial, and project-related advices
Remuneration	They earn interest on capital	They earn fees against their advices
Example	Hire-purchase and leasing companies, insurance services, bill discounting, etc	Merchant banking, portfolio consultancy, issue management, etc

Fund-based institutions are involved with varied activities, which can be evident from its varied classifications given further:

i. *Insurance services* These institutions reduce the risk associated with business such as risk of accident, fire, and other natural calamities.

ii. *Lease financing* These services include provision of fund for usage of assets or an equipment without purchasing it. Hence, leasing implies a contract between two parties for a specified time period.

iii. *Factoring services* These services ensure flow of funds. The relevant institutions assist in reducing seller's risk of bad debt and recovering the debt from the debtors. In most of the cases, this part of business transaction involves cash and credit.

iv. *Hire purchase* These services include purchasing of assets through hire-purchase system. In this system, the repayment is possible through instalments, failing of which leads to return of the asset to the seller.

v. *Venture capital* The investment institutions that provide risk capital to the unregistered, new, less-reputed, risky, and small businesses are known as venture capital funds.

vi. *House financing* These institutions provide services that include sanctioning loan for house building.

vii. *Discounting* Some financial institutions provide the facilities of discounting bills prior to the maturity date. They provide this service against a discounting charge.

Thus, the examples of fund-based financial institutions are lease-financing institutions, insurance organizations, commercial banks, hire-purchase institutions, and housing finance institutions.

b) ***Fee-based financial services***

Fee-based services refer to such specialized services provided by some professionally managed institutions against requisite fees. These services mainly imply technical and financial advices.

The activities of fee-based financial services can be easily understood if we analyse the various types of the services offered.

i. *Portfolio consultancy* This refers to managing of funds of the investors by portfolio consultants. The consultants are experienced, knowledgeable, and competent enough to manage the funds of the clients.

ii. *Merchant banking* Merchant banking refers to the financial services that establish coordination between investors and new entrepreneurs. These merchant banks provide relevant information and advices to their clients and provide the facilities of sale and purchase of securities.

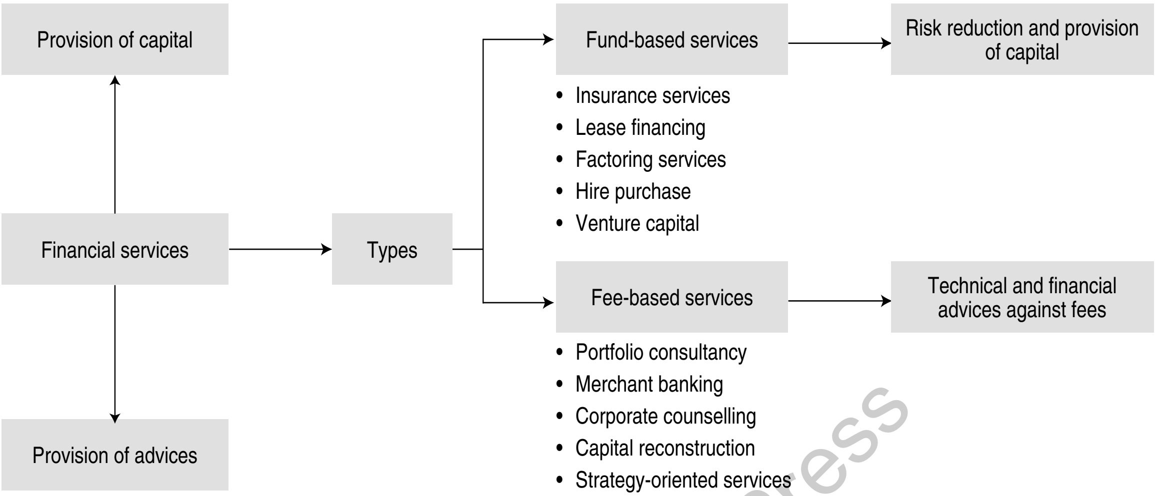

Fig. 1.12 Financial services

iii. *Corporate counselling* In this era of strict rules and regulations, the corporate companies have to maintain various legal and technical obligations. Some financial institutions take care of these rules, and, thus, arrange counselling sessions for these corporates.

iv. *Issue management* Issue management refers to the technical services that some financial institutions provide to the companies during new issue of shares, pricing of issue, etc.

v. *Capital reconstruction* Some financial institutions are involved in capital reorganization of the corporate against proper fees.

vi. *Strategy-oriented service* The business world in recent times are characterized by numerous merger and acquisitions. This process involves various legal and technical complexities. A few financial institutions provide specialized strategy-oriented services to the corporate sector in this context.

Thus, the examples of fee-based services are portfolio consultants, merchant banks, corporate counselling, and issue management services (Fig. 1.12).

1.2.3.5 Financial regulators

Financial system is an integral part of the economy. The economic development of a nation is hugely dependent on the strength and efficiency of the financial system. Hence, it is extremely important to supervise whether the financial system is properly functioning or not. In this context, regulation plays a major role. However, first, we have to know the meaning and implications of regulation.

Regulation is a process of evaluating and analysing whether the pre-determined targets and objectives are fulfilled or not. If any discrepancies are observed, then proper corrective and contractionary measures are adopted so that the discrepancies and faults are not repetitive. The financial system needs to be regulated as protection of an investor's interest is essential for future development of the system.

> Financial regulators generally try to protect the interest of the investors and maintain the financial discipline of the market. Financial market mobilizes the savings of the savers to the business concerns. Naturally, the business and the industrial units are pretty organized, and they can use these huge assets in an improper fashion to maximize the profit. Hence, financial regulators step into this matter by imposing some restrictions and control over the activities of the business concerns. Thus, financial regulators are indispensible for the smooth functioning of the financial system.

1. **Functions** Financial regulatory institutions are involved with the regulation and control of the financial system, which not only protect the interest of the investors but also maintain the financial stability of the nation. The principal functions of the financial regulators are listed further.
   a) ***Investor's protection*** Investors invest in financial market for future returns. Their contribution in capital formation is huge, and, hence, their interests have to be protected for smooth functioning of the financial system in the future. The financial regulators ensure that the interest of the investors will be protected.
   b) ***Regulation of unorganized market*** More the existence of the unorganized financial market in the financial system, more difficult will be the economic development. Hence, financial regulators try to bring all unauthorized institutions under the control of regulatory authority.
   c) ***Strengthening the base of the financial system*** Financial regulators are keen to maintain the financial discipline in the market because any financial turmoil can be dangerous for the investors. Hence, they establish proper coordination between the different segments of the financial market and, thus, strengthen the base of the financial system.
   d) ***Imposition of laws*** Financial regulators impose various restrictions and laws to control the activities of the financial institutions. These measures maintain the faith of the investors on the financial system.
   e) ***Development of capital market*** The financial system of a country cannot develop without healthy and developed capital market. A healthy capital market not only attracts investment but also fosters economic development. Financial regulators frame specific rules and regulations for smooth functioning of the capital market.
   f) ***Restrictions for insurance organizations*** Insurance organizations collect premium from the insured on a regular basis, but often, the insured have to face harassments. Financial regulators ensure that the insurance organizations comply with the existing rules and regulations.
   g) ***Share market intervention*** Financial regulators often intervene in the share market if they notice any mal-practices like insider trading. They undertake strong steps against such illegal practices in the share market. They intend to prevent illegitimate speculations and unethical practices, which create disturbances in the stock market.
   h) ***Economic development*** It has been mentioned earlier that the economic development hugely depends on the efficiency and compactness of the financial system. Financial regulators play an important role in strengthening the base of the financial system. This leads to the possibilities of economic development (Fig. 1.13).

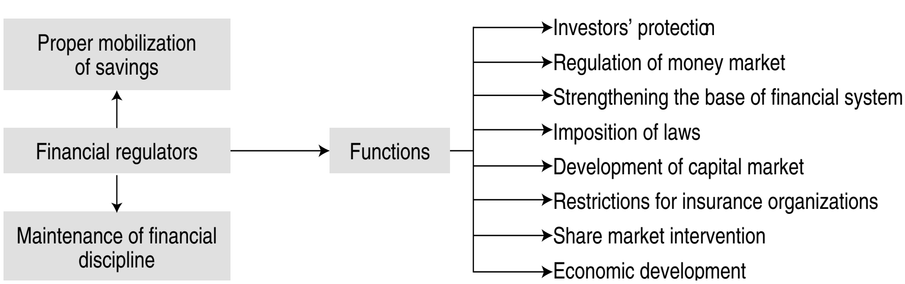

Fig. 1.13 Financial regulators

1.3 TYPES OF FINANCE

Financial system ensures the flow of funds from surplus to deficit units through financial markets. Financial markets take the responsibility of proper allocation of resources. The rational investment of accumulated savings leads to capital formation. However, the source of capital formation can be understood from financial innovations and the growth of financial technology. Hence, this can be analysed under the lights of three different financial situations:

(i) Rudimentary finance (ii) Direct finance (iii) Indirect finance

1.3.1 Rudimentary Finance

Rudimentary finance refers to a financial system or mechanism that can be applicable in the less-developed nations. The rudimentary financial system is characterized by low and diminishing per capita output.

The rudimentary financial environment signifies the absence of financial assets or instruments and the financial markets. The important features of rudimentary finance as identified by us are as follows:

- Rudimentary finance is observed in a traditional economy where the financial system is not sound and proper form of market is absent.
- It is characterized by inefficient allocation of resources.
- Money is the only financial asset in the economy. Owing to absence of other financial assets, investment opportunities are low.
- The financial instrument of the economy is not able to encourage the savings.
- Total savings and investment are inadequate in the economy. Hence, the economy is characterized by a low growth rate.
- The process of capital formation and the pace of economic development is very slow.
- There is no proper mechanism by which savings are accumulated and channelized into a desired direction.
- The financial system is said to be immature due to the absence of the securities market.
- A new form of financial organizations is required to solve the problems of rudimentary finance.

1.3.1.1 Limitations

(i) This system has no mechanism to transform the savings into investment opportunities.
(ii) Owing to the presence of only one financial asset, this system cannot channelize the financial incentives to savings.
(iii) Transaction of securities is not possible due to the lack of different financial markets. Hence, natural process of development gets hampered.
(iv) The system is characterized by a lower tendency of savings as well as a lower rate of growth.

1.3.2 Direct Finance

The saving-investment process does not work efficiently in the rudimentary finance system, which leads to a low rate of growth for the economy. Hence, this called for an alternative and better financial system such as direct and indirect finances.

Direct finance refers to a financial system where savings are directly channelized into investments through the financial market without any intervention of financial intermediaries such as insurance organizations, mutual funds, and other financial institutions.

This type of financial system definitely indicates an improvement over the rudimentary finance system. The main features of the system of direct finance are given further.

The main components of this type of finance are—financial assets or instruments, investment bankers, and brokers and stock exchange.

1.3.2.1 Financial instruments/assets

- It is an important component of direct finance system.
- Economic units here directly collect funds by selling equity shares, debentures, preference shares, etc.
- Owing to the existence of financial assets, direct link between savers and investors are established.
- This leads to a speedy rate of capital formation and economic development.

1.3.2.2 Investment bankers and brokers

- Investment bankers and brokers establish the link between surplus and deficit units.
- These classes of people initiate more flow of funds to the end users.
- Sometimes, they take the responsibility of underwriting of shares issued by various companies in the primary market and, thus, directly collect funds from the primary market.
- Investment institutions directly collect funds from the fund providers by issuing debentures and long-term bonds.
- These institutions almost ensure efficient allocation of resources.

1.3.2.3 Stock exchange or secondary market

- It is known as the secondary market as it deals with already exiting securities.
- The surplus units can be benefited by making transactions in the stock market.
- Stock market provides the facilities of liquidity and easy modes of transaction.
- So, the surplus units will be motivated to save more and make transactions in the secondary market as there is enough liquidity.

1.3.2.4 Limitations

- It is very difficult for the small investors to cope up with this system.
- Direct transfer of funds sometimes may be very expensive.
- Direct finance system sometimes generates inconvenience among the fund providers.
- This system does not work efficiently if stock market is ill-developed.
- This system will be ineffective if the savers are reluctant to invest their savings.

1.3.3 Indirect Finance

In the direct finance system, the small investors suffer as they do not have sufficient knowledge, experience, and training to manage the investment portfolio. On the contrary, large investment institutions can easily channelize their savings by directly purchasing securities from capital market. So, capital formation becomes difficult in the direct finance system. This generates the need for the presence of financial intermediaries in the system, which initiates the indirect finance system.

> Indirect finance refers to the funds that reach to the fund seekers or end users from the surplus generating units through financial intermediary. Thus, financial intermediary establishes the link between savers and investors.

Their presence in the financial system leads to a high rate of capital formation and economic development. Actually, these intermediaries transform the funds in such a way, so that small investors are attracted to invest through these intermediaries. Generally, mutual funds, banks, and insurance organizations act as financial intermediaries.

Indirect finance system with the presence of financial intermediary has the following characteristics:

1. **Efficient utilization of resource** This system ensures the efficient utilization of resource due to the presence of financial intermediaries. They are managed by competent and efficient professionals, who channelize the savings into the productive sectors of the economy.
2. **Capital formation** The system of direct finance is definitely an improvement over the rudimentary finance, but it does not ensure enough capital formation due to the absence of a financial intermediary. On the contrary, indirect finance system with the presence of a financial intermediary is capable of generating capital formation at a greater rate, which in turn promotes economic development.
3. **Possibilities of higher return** Owing to the presence of well-defined financial intermediaries, the investors expect a higher return from their investment. Intermediary institutions are managed by professional experts. Hence, there is a greater possibility of getting higher returns.
4. **Divisibility** In an indirect finance system, financial intermediaries have the ability to convert primary securities of higher value to indirect securities of lower value. This attracts the small investors to invest in these securities.
5. **Diversification** The small investors having lesser amount of funds are not able to diversify their portfolio due to improper knowledge and experience and shortage of funds. However, intermediary institutions accumulate the savings of the small investors and invest it in the various sectors of the economy. This diversification generates the possibility of steady return.
6. **Economies of scale** An individual or a small saver cannot enjoy the economies of scale due to insufficient volume of funds. However, financial intermediaries accumulate the savings of the small investors and channelize it to the fund seekers in such a way so that they are able to enjoy the economies of scale along with a lower transaction cost.
7. **Low degree of risk** The financial intermediaries employ skilled and experienced professionals who take rational decisions regarding selection of assets, timing of purchase, etc. They also diversify the funds in an efficient manner, which is conducive to steady returns and offer lesser degree of risk.
8. **Tax relief** Investment in some mutual funds provides tax relief to the investors. This is beneficial not only for the small investors or organizations but also help in the process of capital formation in the economy. The dividends of the mutual funds are tax free.
9. **Flexibility** Owing to the presence of financial intermediary in the system of indirect finance, the fund seekers enjoy flexibility in the sense that they have to interact only with the intermediary and not with all the lenders (Fig. 1.14).

1.4 STRUCTURE OF INDIAN FINANCIAL SYSTEM

An efficient, compact, well organized financial system is essential for the economic development of a country. It is worth mentioning that a proper expansion of the financial structure increases the pace of the economic development. This financial structure is affected by the financial policies adopted in different era.

Indian financial system adjusted in accordance with the financial policies adopted in different phases. However, the financial system in India experienced a lot of changes after the adoption of a new economic policy in the early nineties. The financial system in India can be discussed on the basis of three different phases:

(i) Phase 1: Pre-1951 or pre-planning era
(ii) Phase 2: 1951 to late 1980s
(iii) Phase 3: Post-1990 or post-liberalization era

We will initially discuss the features of the financial system in India during these phases.

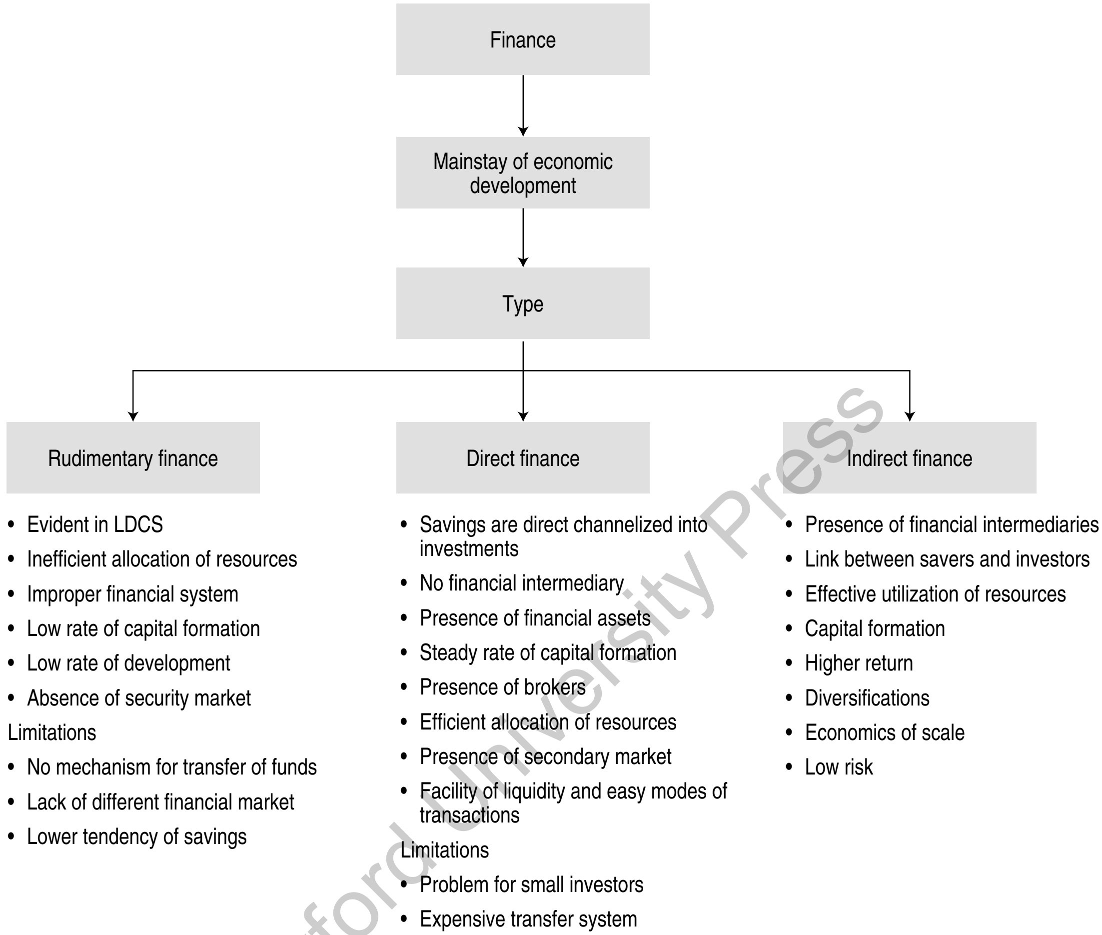

Fig. 1.14 Types of finance

1.4.1 Phase 1: Pre-1951 or Pre-planning Era

In this era, Indian financial system was traditional. There was no scope of financial innovations and technology. The per capita income of the economy was very low and almost stagnant. Industrial initiative was almost absent. The credit market was unorganized. The industrial performance was very poor. There were no financial institutions that provided long-term credit to the industries. There was restricted access of industries to the external savings. On the whole, the financial system failed to realize the importance of industrial investment. Entrepreneurship was absolutely absent. Accordingly, the rate of industrial development was extremely frustrating.

Since the economy in this phase was traditional, the financial system was rudimentary in nature. The financial system was characterized by an unplanned economic development. As the investment opportunities were very low, the rate of capital formation was also poor. The lack of institutional facilities led to the dismal performance of the Indian industries in this phase.

1.4.2 Phase 2: 1951 to Late 1980s

In this phase, efforts were made to coordinate the activities of the government and financial system. Government felt that, for the successful implementation of its policy, it was extremely important to construct a sound, well-organized, and compact financial system. Hence, the government focused on the development of the financial system. This was required for a planned economic development. Government imposed its control over the financial institutions so that the planned objectives and priorities can be fulfilled. The regulatory financial framework was necessary to establish coordination between government objectives and activities of the financial system.

The main features of this phase of planned economic development are described further.

1.4.2.1 Acquisition of the financial institutions by the government

This phase was characterized by public ownership of financial institutions. The objective behind it was the government could exercise the financial control over them. In 1956, Imperial Bank of India was nationalized and renamed as State Bank of India (SBI). In 1956, more than 200 life insurance companies were nationalized and merged to establish Life Insurance Corporation of India (LICI). In 1964, Unit Trust of India (UTI) was established as a public statutory body, which started to sell units to the public. In 1969, around 14 commercial banks were nationalized. In 1972, all general insurance companies were nationalized and together gave birth to General Insurance Corporation of India (GICI). In addition, government established various long-term financial institutions as development banks in this era. Thus, government imposed control over the entire financial system in this phase.

1.4.2.2 Strengthening institutional infrastructure

In this second phase of financial system in India, government made serious efforts to strengthen the institutional infrastructure specially by establishing various term lending institutions, which would provide long-term finance to the industries. These institutions are owned by the government, and, hence, they also tried to achieve the socio-economic goal of the economic planning. The notable institutions that were established in this phase to strengthen the industrial base are

- Industrial Finance Corporation (IFC), 1948
- State Financial Corporations (SFC), SFC Act, 1951
- National Industries Development Corporation (NIDC), 1954
- The National Small Industries Corporation Limited, 1955
- Industrial Credit and Investment Corporation of India (ICICI), 1955
- Life Insurance Corporation of India (LICI), 1956
- Industrial Development Bank of India (IDBI), 1964
- Unit Trust of India (UTI), 1964
- Industrial Reconstruction Bank of India (IRBI), 1971
- General Insurance Corporation of India (GICI), 1972
- Technical Consultancy Organizations (TCO)
- Small Industries Development Bank of India (SIDBI), 1990

1.4.2.3 Ensuring investors' protection

In this second phase, investment was encouraged by the government so that enough funds were available to the industries. However, to protect the interest of the investors, the government opted for serious regulatory measures. RBI was already there in this phase, which imposed various rules and regulations in the financial market. Government established various regulatory institutions in this phase so that the investors could keep their faith on the financial system. The important financial regulators in this phase were

- Reserve Bank of India (RBI) (since 1935)
- Ministry of Finance
- Securities and Exchange Board of India (SEBI) (1988)

1.4.3 Phase 3: Post-1990 or Post-liberalization Era

The organizational structure of the Indian financial system had to adjust a lot in the backdrop of the economic liberalization. In fact, we have experienced a lot of changes in the Indian financial system after the adoption of the new economic policy. Indian economy has been exposed to the international market. The Indian economic development becomes hugely dependent on globalization, privatization, and liberalization. Apart from opening up the economy, government have also focused on internal reforms. The industrial licensing policy has been removed. The trade has been liberalized. The government has adopted financial sector reform measures. In most of the cases, the subsidies have been withdrawn. All these measures adopted by government exert a huge impact on industrial sector of the nation. Owing to this market-friendly system, the relative importance of the government has been drastically reduced, and accordingly, the influence of government on economic activities started to diminish significantly. On the whole, the financial system becomes market oriented. Capital market has emerged as the prime centre of investment, and the Indian financial market has witnessed capital market-oriented development. The main features of this era are discussed further.

1.4.3.1 Privatization of financial institutions

In the second phase, the entire financial institutions of India were controlled by the government. Most of the investment institutions and development banks were set up under the ownership of the public sector. The mutual funds were controlled by SEBI guidelines, and the activities of the private sector banks were controlled by RBI. However, after 1991, many private sector banks are established, which are allowed to issue bonds and equity shares. The private sector insurance companies are allowed to enter the insurance business of India.

1.4.3.2 Reorganization of institutional infrastructure

After the adoption of new economic policy in 1991, the institutional infrastructure of the country had to be reorganized. The financial activities become capital market oriented. The role and the policies of the financial organizations were redefined. The important changes faced by the financial sector can be listed in the following way:

- The development banks and financial institutions have introduced floating rates of interest. Some of the development banks have focused on the promotion of institutional infrastructure to initiate capital market-oriented activities. Some credit-rating institutions such as Credit Rating Information Services of India Ltd. (CRISIL), CARE, and ICRA started to evaluate the credit-worthiness of various financial institutions. Over-the-Counter Exchange of India (OTCEI) and National Stock Exchange of India (NSE) are established to satisfy the growing needs of the capital market.
- Commercial banks started to obey the recommendations of the Narasimham committee. Various measures are adopted. There is a change in the cash-reserve ratio and statutory-liquidity ratio. The review of these ratios is done on a regular basis.
- The security market becomes the most important sector of the financial market.
- Mutual funds have emerged as the mainstay of the Indian capital market. They accumulate the small savings of the investors and regularly introduce new schemes to attract the investors.
- In the money market, interest rates have been regulated and many new instruments such as 14 days and 28 days Treasury bills have been introduced.

1.4.3.3 Capital market-oriented activities

As we have mentioned earlier, with the liberalization strategy adopted by the Government of India in 1991, the capital market-oriented activities started to flourish. The financial institutions have shifted their focus in promoting the capital market. The important activities can be summarized as:

- The commercial banks have started to develop various capital market-oriented activities.
- The secondary market operations are being controlled by SEBI.
- The securities market has been reformed. OTCEI, NSDL, and NSE are formed to meet the ever-increasing pressures of the capital market.
- Mutual funds gained a lot of importance.

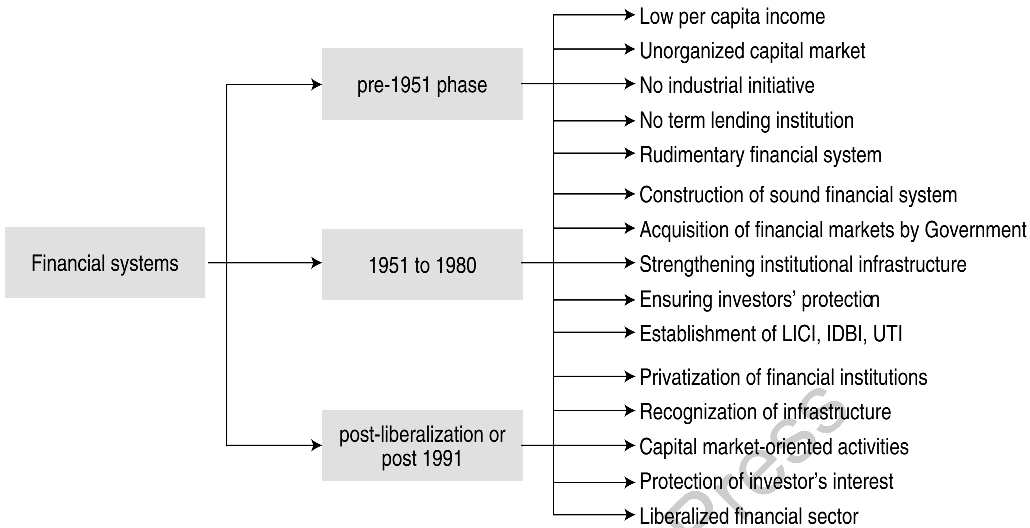

Fig. 1.15 Phases of financial system

1.4.3.4 Protection of investors' interest

In the era of globalization, it is evident that the investors have emerged as the backbone of the financial system. Hence, the government is keen to protect the interest of the investors. They have introduced a lot of measures and established various institutions for protecting the interest of the investors. The institutions that are protecting the interest of the investors are

- Reserve Bank of India
- Ministry of Finance
- Securities and Exchange Board of India
- Insurance Regulatory Development Authority (IRDA)

Thus, in this post-liberalization phase, not only the Indian financial system expanded, but we have also experienced various innovations and diversifications. In recent times, the Indian financial system is regarded as a well-organized, sound, compact, and rich financial system. The various organizational changes, globalization, privatization, and liberalization strategies and internal reforms have brought significant revolutionary changes in the Indian financial system (Fig. 1.15).

1.5 ORGANIZATIONAL STRUCTURE OF THE INDIAN FINANCIAL SYSTEM

The analysis of the Indian financial system will remain incomplete if we do not focus on the organizational structure of the Indian financial system. Basically, this internal structure is the determinant of the efficiency and competence of the financial system. The financial system in India has its own characteristics by which it can be distinguished from others. After the adoption of new economic policy, the organizational structure of the Indian financial system has changed a lot. However, these alterations are compatible with the changing scenario of the world economy.

As mentioned earlier, the Indian financial system can be divided into the following five mutually interdependent components:

(i) Financial institutions
(ii) Financial markets
(iii) Financial instruments
(iv) Financial services
(v) Financial regulators

1.5.1 Financial Institutions

Financial institutions are regarded as the integral part of the financial system. They mobilize savings on one hand and work as a supplier of credit on the other hand.

1.5.1.1 Classification

In most of the cases, we observe more or less similar functions by the financial institutions. However, in India, we can classify the financial institutions on the basis of primary functions and degree of specialization. As, Section 1.2.3.1, the features of these components were analysed, in this section, we are only providing the examples of the components.

1. **Financial intermediary** Financial intermediaries in India play a vital role in strengthening the financial system. It refers to such institutions that facilitate the process of transfer of fund from fund providers to fund seekers and, thus, mobilize the savings.
   a) ***Classification of the financial intermediaries*** We can divide the financial intermediaries in India into two distinct components on the basis of the activities and structure.
      i. *Banking intermediary* State Bank of India (SBI), United Bank of India (UBI), United Commercial Bank (UCO Bank), and Indian Bank are some examples of banking intermediary in India. However, RBI is the central bank of India, which has the power to control all the banking institutions of India.
      ii. *Non-banking intermediary* The non-banking intermediaries cannot be treated as banks, though they have similarities with the banking institutions. In India, LICI, UTI, mutual funds, Housing and Urban Development Corporation (HUDCO), etc are treated as non-banking intermediaries.
2. **Financial non-intermediary** Financial non-intermediaries do not work as a medium between fund providers and fund seekers. In India, IFCI, National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), etc are treated as the examples of financial non-intermediaries.
3. **Other financial institutions** These financial institutions neither act as a medium nor involve in direct investment. ECGC, TCO, CRISIL, and Discount and Finance House of India (DFHI) can be regarded as the examples of other financial institutions in India.

1.5.2 Financial Markets

Financial market refers to a centre that provides the facilities of sale and purchase of financial claims and services. The financial markets in India can be classified as outlined in section 1.2.3.2:

(i) On the basis of the nature of securities: primary and secondary markets
(ii) On the basis of the period/tenure of maturity: money and capital markets
(iii) On the basis of nature of transactions: organized and unorganized markets

1.5.3 Financial Instruments

Financial instruments are one of the principal components of the financial system.

On the basis of the maturity, financial instruments can be classified into:

(i) Short-term financial instruments
(ii) Medium-term financial instruments
(iii) Long-term financial instruments

The details of the aforementioned types are outlined in section 1.2.3.3.

In India, Indira Vikas Patra (non-existent now), Kisan Vikas Patra, National Savings Certificate, Zero-coupon Bonds, National Development Bonds, HUDCO bonds, and National Highway Authority of India

(NHAI) bonds are important financial instruments. In India, some financial instruments issued by companies are Secured Premium Notes (SPN), Third-party Convertible Debentures (TPCD), etc. The financial instruments issued by companies are floating-rate bonds (FRB), step-up liquidity bonds (SULB), etc.

1.5.4 Financial Services

Financial services are financial institutions that provide various fund-based and advisory services to the business and industrial units.

1.5.4.1 Types of financial services

We can categorize the financial services under the following heads:

1. **Fund-based financial services** Fund-based financial institutions refer to institutions that assist other organizations by reducing risk and providing capital. Fund-based institutions in India are involved with varied activities, which can be evident from its different classifications such as insurance services (LICI and GICI), lease financing and hire purchase (Bajaj Finance, Sundaram finance, Cholamandalam, SREI infrastructure, etc), factoring services (SBI Factors and Commercial Services Ltd), venture capital (Risk Capital and Technology Finance Corporation Ltd, Technology Development and Information Company of India Ltd), house financing (National Housing Bank), and discounting (Discount and Finance House of India and ICICI).
2. **Fee-based financial services** Fee-based services refer to such specialized services provided by some professionally managed institutions against requisite fees.

The examples of fee-based services are portfolio consultants (SBI Capital Markets Ltd, Bajaj Capital, etc) merchant banks (SBI, Kotak Mahindra Capital, and ICICI Securities) corporate counselling (Indian Institute of Counselling), credit rating services (CRISIL and CARE), etc.

1.5.5 Financial Regulators

Financial regulators generally try to protect the interest of the investors and maintain the financial discipline of the market.

In India, the main financial regulators are RBI, Ministry of Finance, SEBI, IRDA, National Company Law Tribunal (NCLT), etc.

1.6 REFORM OR CHANGES IN THE INDIAN FINANCIAL SECTOR

The Indian financial sector has undergone major changes after the introduction of the new economic policy in India in 1991. This era may be described as the era of liberalization, privatization, and globalization. These policies aimed at transforming the Indian economy from a controlled economy to a liberalized economy. This called for a reform in the financial sector in India.

In 1969, the commercial banks were nationalized, which strengthened the base of financial sector. In the past few decades, we observed expansion of rural branches, diversification of banking activities, priority sector lending, impressive increase in the bank credit, deposit mobilization, and, most importantly, reduction in population per bank. All these events implied the commendable performances of the banking system. However, in spite of these successes, the banking sector faced some serious problems.

The debt-recovery ratio became very poor due to the unintended political and administrative interferences. The nationalized commercial banks were forced to provide loans at a concessional rate to the priority sector, which eventually reduced their profits. Over employment, absence of competitive environment, and lack of work culture led to deteriorated banking services. A reform was necessary to improve the performance of the financial sector. Moreover, the Indian financial sector had to be compatible with the changing aspects of the Indian economy.

To strengthen the banking and financial sector economically, Government of India appointed a committee under the chairmanship of M. Narasimham. The committee in 1991 made the following recommendations:

1. **Restructuring of the banking system** The committee recommended a four-tier structure of banking system, which will comprise three or four international and large banks, 8–10 national banks with the network throughout the nation, local banks with activities in specific areas, and rural banks whose activities are confined to rural areas.
2. **Abolition of dual control system over banks** The committee recommended to abolish the dual control over banks and favoured a new quasi-autonomous body under RBI to take the responsibility of supervision. RBI should act as the primary agency of regulatory activities.
3. **Removal of licensing** The committee recommended no further nationalization of banks. It proposed for the removal of branch licensing. It also recommended that foreign and private banks will be allowed to open branches in the country. This will create a competitive environment.
4. **Asset reconstruction fund (ARF)** The committee recommended for establishment of ARF to ensure quick recovery of loans. A special tribunal should be set up in this context.
5. **Interest rate deregulation** The committee recommended to deregulate the interest rate on loan and government borrowings gradually. However, interest rates on the bank deposits should be regulated.
6. **Reduction in CRR and SLR** The committee strongly recommended bringing down the Statutory Liquidity Ratio (SLR) from 38.5 to 25 per cent in a phased manner. It also recommended reducing the Cast Reserve Ratio (CRR).
7. **Expansion of capital base** The committee recommended that the banks should be permitted to raise fresh capital from the public. It also prescribed that commercial banks should achieve at least 4 and 8 per cent capital-adequacy ratio relative to risk-weighted assets by March 1993 and March 1996, respectively.
8. **Non-discrimination** Foreign banks should satisfy the same requirements as applicable to the Indian banks for opening the branches or subsidiaries.
9. **Abolition of prior approval** The committee recommended for rejection of prior approval of government or SEBI regarding new issues. The issuing company is free to decide on the terms and conditions.
10. **Redefined role of priority sector** The priority sector should comprise small and marginal farmers, small and cottage industries, rural artisans, etc, and credit target for this group should be 10 per cent of total credit.

Most of these recommendations were accepted by Government of India. More focus was given to the diversified activities of the banks. Some eminent economists opined that, this entry of foreign banks might reduce the employment opportunities as most of the foreign banks utilize labour-saving techniques. They predicted more income inequality in the country. However, the proponents of the reforms refuted this argument.

Government of India again appointed a committee under M. Narasimham in 1997 to review the situations of the financial sector. The committee also examined whether the initial recommendations were properly recommended or not. The committee submitted its report in 1998. The following reform measures were undertaken on the basis of these recommendations:

- The commercial banks are now free to determine their prime lending rates (PLR) for commercial credit. PLR has been converted into a benchmark rate for banks.
- Capital adequacy norm should be at least 10 per cent.

- For quick recovery of loans, an ordinance was passed. RBI has introduced Interim Liquidity Adjustment Facility (ILAF) instead of General Release Facility (GRF).
- CRR was gradually lowered from 15 per cent to single digit in the era of financial sector reforms. According to RBI (Amendment) Act, 2006, the floor of 3 per cent and the ceiling of 20 per cent (in case of CRR) was removed.
- Financial assistance should be stopped for recapitalization of banks.
- Since March 2000, capital-adequacy ratio has been increased to 9 per cent.
- Since 1992–93, prudential accounting norms have been introduced.
- In 2000, guidelines for licensing new banks were issued according to which the initial minimum capital should be raised from ₹ 200 to ₹ 300 billion. NRI participation in the primary equity of a newly established bank shall be to the maximum extent of 40 per cent.
- The banks have been directed to set up Assets Liability Management (ALM) systems.
- Special recovery tribunals had been set up in Delhi, Kolkata, Ahmedabad, Jaipur, and Bangalore for recovery of arrear loans.

Presently, the government has adopted a multidimensional strategy that focuses on creation of a competitive environment in the Indian financial sector. The government aims at the development of money market and capital market. Discount houses are established. The introduction of credit-rating agencies hugely facilitates the investors. The mutual funds are performing an aggressive role to attract the small investors. The securities market has undergone vivid structural changes. The establishment of OTCEI, NSE, and NSDL led to the smoothening of capital market operations. The insurance sector is developing gradually after allowing private and foreign insurance companies to conduct insurance business in India. Thus, the government tries to create a congenial economic environment for investment in the country in the post-liberalization period through the financial sector reforms (Fig. 1.16).

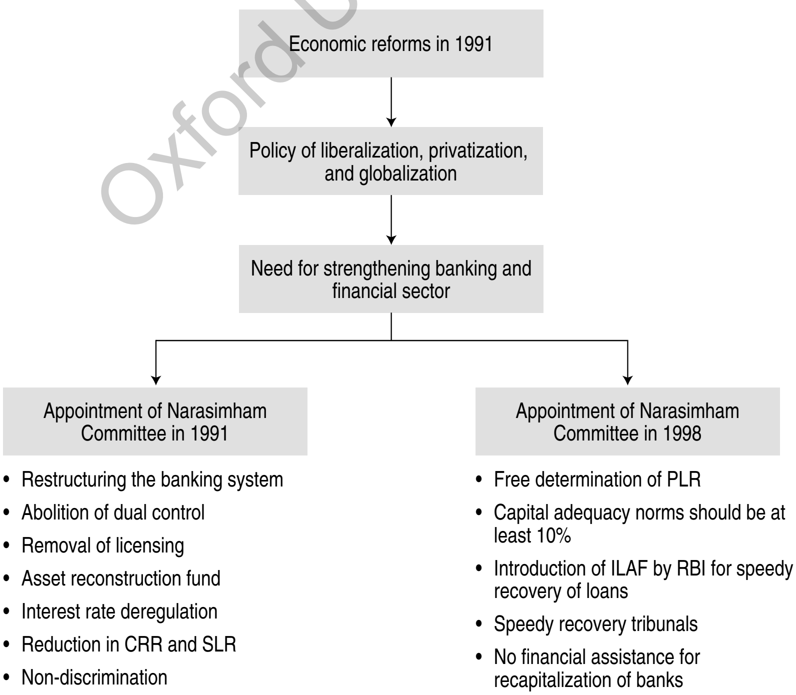

Fig. 1.16 Reforms in the Indian financial sector

SUMMARY

- Finance is the life blood of the industry. It establishes the link between savers and investors. It leads to optimal utilization of resources.
- Financial system acts as an intermediary between surplus and deficit units of the economy. Thus, the financial system ensures the flow of funds from fund providers to fund seekers.
- Financial system helps in mobilization of savings, capital formation, and economic development.
- Financial system is divided into financial institutions, financial markets, financial instruments, financial services, and financial regulators.
- Financial institutions are regarded as the integral part of the financial system. They mobilize savings on one hand and work as a supplier of credit on the other hand. It is divided into financial intermediary, non-intermediary, and others.
- Financial intermediary refers to banking intermediary (SBI) and non-banking intermediary (LICI). Financial intermediaries ensure flow of funds from surplus to deficit units.
- Financial market refers to a centre that provides the facilities of sale and purchase of financial claims and services.
- On the basis of tenure, financial markets are divided into primary and secondary markets.
- The financial market that deals with new financial claims or securities is known as primary market. As this part of financial market deals with new securities, it is also known as 'new issue market'.
- The financial market that deals with the already existing or new securities is known as secondary market.
- On the basis of maturity period, financial market can be divided into money and capital market. The financial market that deals with short-term securities and claims (with a period of maturity of one year or less) is known as money market. The financial market which deals with the long-term claims and, like money market, ensures the flow of funds from surplus to deficit units is known as capital market.
- Financial instruments are one of the principal components of the financial system. Financial instruments or assets, which are heterogeneous in nature, refer to the legal claims associated with a future cash flow. Financial instruments play a major role in mobilizing the financial market.
- Financial services refer to various fund-based and advisory services to the business and industrial units offered by financial institutions.
- Fund-based financial institutions refer to institutions that assist other organizations by reducing risk and providing capital. Fee-based services refer to specialized services provided by some professionally managed institutions against requisite fees.
- Financial regulators generally try to protect the interest of the investors and maintain the financial discipline of the market.
- Finance is of three types—rudimentary, direct, and indirect.
- The rudimentary financial system is required in an economy characterized by low and diminishing per capita output. Direct finance refers to a financial system where savings are directly channelized into investments through the financial market without any intervention of financial intermediaries. Indirect finance refers to the funds that reach to the fund seekers or end users from the surplus generating units through financial intermediary.
- In pre-1951 or pre-planning era, Indian financial system was traditional. There was no scope of financial innovations and technology.
- In Phase 2, that is, in between 1951 and late 1980s, efforts were made to coordinate the activities of the government and financial system.
- In Phase 3, that is, in post-1990 or post-liberalization era, the industrial licensing policy has been removed. The trade has been liberalized. The main features of this era are privatization of financial institutions, reorganization of institutional infrastructure, and capital market-oriented activities.
- The Indian financial sector has undergone major changes after the introduction of the new economic policy in India in the year 1991.
- In order to strengthen the banking and financial sector economically, Government of India appointed a committee under the chairmanship of M. Narasimham. The committee in 1991 made the following recommendations:
  a. Restructuring of the banking system
  b. Abolition of dual control system over banks
  c. Removal of licensing
  d. Interest rate deregulation

GLOSSARY

Banking intermediaries directly participate in the payment mechanism and various transactions. They together can create money or credit.
Capital market is that part of financial market, which deals with the long-term claims and, like money market, ensures the flow of funds from surplus to deficit units.
Direct finance refers to a financial system where savings are directly channelized into investments through the financial market without any intervention of financial intermediaries such as insurance organizations, mutual funds, and other financial institutions.
Fee-based services refer to the specialized services provided by some professionally managed institutions against requisite fees. These services mainly imply technical and financial advices.

Finance is referred to be the mainstay of the economy as it is adequately required to perform various economic activities such as development of infrastructure, creation of employment opportunities, economic development, and establishment of industries.
Financial institutions refer to the institutions that act as intermediaries in the transfer of funds from surplus to deficit units and, thus, mobilize savings in the economy.
Financial instruments or assets, which are heterogeneous in nature, refer to the legal claims associated with a future cash flow.
Financial intermediaries refer to institutions that facilitate the process of transfer of fund from fund providers to fund seekers and, thus, mobilize the savings.
Financial market refers to a centre that provides the facilities of sale and purchase of financial claims and services.
Financial non-intermediaries do not work as a medium between fund providers and fund seekers. They do not accept any deposit from the general public. They actively take part in the business and sometimes invest in the proper sector
Financial regulators refer to institutions that generally try to protect the interest of the investors and maintain the financial discipline of the market.
Financial services are financial institutions that provide various fund-based and advisory services to the business and industrial units.
Financial system is a combination of various complex and mutually interdependent financial activities, which also acts as a connecting link between savers and investors to fulfil a certain and predetermined objective.
Fund-based financial institutions refer to institutions that assist other organizations by reducing risk and providing capital.
Indirect finance refers to the funds that reach the fund seekers or end users from the surplus generating units through financial intermediary.
Long-term instruments refer to those financial assets that can be redeemed by the investor or repaid or returned by the issuing institutions with fixed interest to the investor after the completion of at least 5 years.
Medium-term instruments refer to those financial assets that can be redeemed by the investor or repaid or returned by the issuing institutions with fixed interest to the investor within a period of 1–5 years.
Money market is that part of financial market, which deals with short-term securities and claims (with a period of maturity of 1 year or less).
Non-banking intermediaries collect term deposits from the public and provide medium- and long-term credit to the industrial units. They cannot create credit but play an important part in risk reduction and creation of new assets.
Organized market can be defined as that part of financial market where the transaction occurs according to the specific rules and regulations.
Primary market deals with new financial claims or securities. As this part of financial market deals with new securities, it is also known as 'new issue market'.
Rudimentary finance refers to a financial system or mechanism, which can be applicable in the less-developed nations. It is characterized by inefficient allocation of resources.
Secondary market deals with the already existing or new securities. Thus, in the secondary market, existing securities are sold and purchased.
Short-term instruments refer to those financial assets that can be redeemed by the investor or repaid by the issuing institutions with fixed interest to the investor within a short period of time (less than 1 year).
Unorganized market is that part of financial market where the transactions occur without any well-defined structure and rules.

MULTIPLE CHOICE QUESTIONS

1. A financial system ensures the flow of funds from
   (a) Investors to savers
   (b) Savers to investors
   (c) Investors to government
   (d) Government to financial institutions
2. Which one of the following is not termed as a financial regulator?
   (a) RBI (b) SEBI
   (c) IDBI (d) IRDA
3. Which one of the following is not recommended by the Narasimham Committee?
   (a) Restructuring of the banking system
   (b) Abolition of dual control system over banks
   (c) Removal of licensing
   (d) Interest rate regulation
4. In which of the following eras, the Indian financial system was characterized by a lack of financial innovation?
   (a) Post-liberalization phase
   (b) In the mid-1960s
   (c) In pre-1951
   (d) In between 1950 and 1980
5. UTI was established in
   (a) 1956 (b) 1948
   (c) 1964 (d) 1960
6. Banking institutions
   (a) Are capable of creating credit
   (b) Accept deposit directly from public
   (c) None of the above
   (d) Both (a) and (b)

7. Which one of the following is an example of a financial non-intermediary?
   (a) IFCI (b) SBI
   (c) LICI (d) UBI
8. Non-banking intermediaries
   (a) Reduce risk
   (b) Create credit
   (c) Take the responsibilities of underwriting
   (d) Create new asset
9. Which of the following is neither an intermediary nor a non-intermediary?
   (a) LICI (b) UTI
   (c) ECGC (d) All of the above
10. Which of these markets deals with new securities?
   (a) Secondary market (b) Primary market
   (c) New-issue market (d) Both (b) and (c)
11. In which market, the coordination among different units are strong?
   (a) Organized market
   (b) Unorganized market
   (c) Rural traditional credit market
   (d) None of the above
12. The medium-term financial instruments are redeemable
   (a) Within 1 year (b) Within 1–5 years
   (c) After 5 years (d) Within 5–10 years
13. Portfolio consultancy is an example of
   (a) Fund-based financial services
   (b) Fee-based financial services
   (c) Activities of RBI
   (d) None of the above
14. Financial regulators
   (a) Strengthen the base of the financial market
   (b) Intervene in the share market
   (c) Both (a) and (b)
   (d) Are not an important part of a financial system
15. One of the main features of the rudimentary financial system is
   (a) Direct collection of funds
   (b) Financial intermediaries play a vital role
   (c) Stock exchanges are an integral part
   (d) Inefficient allocation of resources
16. Which of the following institutions were established in the pre-independence period?
   (a) Reserve Bank of India
   (b) Unit Trust of India
   (c) Security and Exchange Board of India
   (d) General Insurance Corporation of India
17. First Narasimham Committee was formed in
   (a) 1990 (b) 1991
   (c) 1984 (d) 1969

EXERCISES

Short Answer Type Questions — 5 Marks

1. Explain the role of finance briefly.
2. Show how the funds flow from surplus to deficit units through a financial system.
3. What are the components of a financial system?
4. What are the functions of financial services institutions in a financial system?
5. How do the financial instruments help in the smooth functioning of the financial system?
6. Distinguish between the financial intermediary and financial non-intermediary.
7. Define financial institutions. What are the functions of the financial institutions?

Essay Type Questions — 10 Marks

1. Define a financial system. Mention its significance and functions.
2. Write a brief note on the financial system of a country.
3. Explain the significance of financial intermediary.
4. Discuss the role of financial institutions in the financial system.
5. What is the relevance of a financial market in a financial system?
6. Define financial regulator. What is the role of financial regulators in the financial system?
7. Discuss the different types of finance in a financial system.
8. Discuss the organizational structure of the Indian financial system with examples.
9. Distinguish between
   (i) Banking and non-banking institutions
   (ii) Fund-based and fee-based financial services
10. What are the features of rudimentary finance?