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# INDIAN FINANCIAL SYSTEM

## UNIT – I

### 1. Financial System (An introduction/ Definition):

Financial system in general term relates to a system in existence wherein financial instruments are dealt in or financial services are carried out. It is basically an intermediary acting as a bridge between the savers & investors thereby playing a major role in the economic development of a country.

Definitions by Prof. Robinson (primary function-to provide link-between saving & investment-to create new wealth-and permit portfolio adjustment for existing wealth)

Definition by Prof. Christy (objective-to supply fund-to various sectors-to provide fuller utilization of resources- without affecting consequences of price level change and individual desire)

## 2. INDIAN FINANCIAL SYSTEM:

Indian Financial system is a complex and developing financial system. The IFS works not only on the basis of the market mechanism but relies heavily on the Government and agencies and Bodies established by the Government. With globalization and modernization, the IFS is changing constantly and keeping itself in pace with the global challenges. IFS is regarded as one of the major financial system in the global scenario today.

## 3. COMPONENTS OF IFS:

a. Financial markets-
- ✓ Money market-Short term nature & monitored by RBI
- ✓ Capital market- Long term funds & regulated by SEBI
- ✓ Primary market/New Issue market
- ✓ Secondary market/Stock Exchanges

b. Financial institutions & Intermediaries
- ✓ Commercial Banks- public sector, private sector & foreign banks
- ✓ Non Banking Financial Companies(NBFC's)
- ✓ Development financial institutions/Public financial institutions- IFCI,ICICI,IDBI,SIDBI, IIBI SFC's, SIDC's, SIIC's, TCD's.
- ✓ Mutual Funds- UTI (established in 1964)
- ✓ Insurance organizations- LIC, GIC and now private institutions as well
- ✓ Foreign private capital

c. Financial assets, instruments & securities
- ✓ Equity shares
- ✓ Preference shares
- ✓ Debentures
- ✓ Innovative instruments- having new outlook and characteristics.

d. Financial services- being granted to industrial enterprise/corporate by the Financial players in the markets(Financial intermediaries)

## 4. FEATURES/ CHARACTERISTICS OF IFS

Plays many roles, Predominance of public sector, Quick transactions, Effective competition, Sophisticated Integrated and Progressive, Reduction in transaction cost, Major expansion in international transactions, Control on administrative rates relaxed, *Being ruled by financial intermediaries, Monitored by Govt & Govt. agencies.*

## 5. STRUCTURE OF IFS

Indian Financial System- Money Market Capital Market

1) Money Market- short term
    a. Unorganised banking sector
    b. Organised banking sector
    c. Sub market
        i. Call money market
        ii. Short term bill market
            - Bill of Exchange
            - Treasury bills
        iii. 182 days treasury bill market
        iv. Certificate of deposits
        v. Commercial papers

2) Capital market- long term
    a. Gilt edged market- market for Govt/Semi-Govt. securities
    b. Industrial security market
        - New Issue/Primary market
        - Stock Exchange/Secondary market
    c. Development Financial Institutions
        - IFCI-Industrial financial Corporation Of India(set up in 1948)
        - ICICI
        - IDBI (Industrial Development Bank of India)
        - SIDBI ((Small Industries Development bank of India)
        - IRBI (Industrial reconstruction Bank of India)
        - UTI (Unit trust of India)

d. Financial intermediaries
- Merchant Bankers
- Mutual Fund institutions
- Leasing Company

Financial system further classified as:- Industrial finance, Agriculture finance, Development finance (fund needed for development), Government finance (to meet govt. expenditure).

## 6. MAJOR REFORMS IN IFS POST 1991/POST ECONOMIC LIBERALISATION PERIOD:

a. Systematic & Policy Reforms-

i. Deregulation of interest rates
ii. SLR reforms(interest provided based on market rate)
iii. CRR reforms (incremental 10% CRR removed, CRR reduced from 15% to 10%)
iv. The Basle Committee Framework suggesting capital adequacy norms for banks, FI's adopted.
v. BFS (Board of Financial supervision) under monitoring of RBI established.
vi. Recovery of debt due to Banks & Financial Institutions Act,1993 passed
vii. Ceiling on adhoc treasury bill for managing budget deficit.
viii. Private sector entry allowed in Banks, Mutual funds, Insurance
ix. SEBI made statutory body in Feb,1992
x. OTCEI & NSE established and made operational
xi. Floating interest rates on financial assistance introduced

b. Banking Reforms:

i. Interest rates on deposit and advances de-regulated
ii. SBI and other nationalized bank were given entry in Capital market
iii. Prudential norms introduced in accounting
iv. Balance sheet disclosure by Banks to conform to International Accounts Standards Committee norms.

v. Branch opening and shifting by bank was given freedom
vi. Budget support given to weak banks
vii. Banking Ombudsman Scheme 1995 introduced
viii. Loan system introduced
ix. Bank free to fix foreign exchange open position limit subject to RBI approval

c. Primary & Secondary stock market reforms:
i. Commission /Discount on allotment prohibited
ii. Mutual Funds permitted to underwrite public issue
iii. Ceiling of Rs.10 crore imposed on stock market doing business of financing carry forward transaction
iv. Depositories Act,1996 passed
v. Stock lending scheme introduced
vi. Listing agreements of Stock exchanges modified for better investor protection
vii. Stock exchanges were mordernised
viii. Stock exchanges were required to institute the buying or auction process

d. Government securities Market reform:
i. 394 days treasury bill replaced by 182 days treasury bill from 1992-93
ii. 91 days treasury bill sale started by auction process from Jan,1993
iii. Central Govt Securities maturity period reduced from 20 to 10 yrs and State govt securities maturity period reduced from 15 to 10 years
iv. State Govt & PF allowed to participate in auction of 91 days Treasury Bills
v. A scheme allowing RBI to auction Govt securities out of its own holding
vi. Zero Coupon Bond, Tap stock, Floating rate bond, Capital index bond, etc introduced
vii. The institution of primary dealers in Govt. securities market established
viii. Reverse Repo Rate facility with RBI in Govt dated securities extended to DFHI & STCI

e. External Financial market reforms:
   i. Foreign Institutional Investors(FII's) permitted to invest in Indian capital market
   ii. Indian companies permitted to access International capital market
   iii. FERA,1973 replaced by FEMA,1999
   iv. Rate of Long term Capital gain for NRI's reduced from 20% to 10%
   v. FII's & NRI's permitted to invest upto 24% in equity of Indian companies except in those engaged in agriculture & plantation
   vi. RBI entrusted as single window clearance for sanctioning overseas investment proposal by Indian Companies
   vii. FIPB reconstituted as FIPC to promote FDI
   viii. Flexible exchange rate system introduced

## 7. <u>OVERVIEW OF IFS</u>

a. **Stage 1-:Pre- independence**: unorganized, very few securities, no separate issuing institution, almost nil financial intermediaries, industries didn't have access to outside savings

b. **Stage 2:- Post-Independence till 1990**: ownership transferred from private to public, nationalization of RBI(1949), Setting up of SBI(1st July,1955), Nationalization of LIC, GIC, Setting up of Financial Institutions & investing institutions, Changing role of banks

c. **Stage 3:- After 1990**: Entry of private sector, Development Financial Institutions role changed, Emergence of NBFC, Growth of mutual fund industry, Establishment of SEBI, Development in secondary market, introduction of derivatives trading, private sector in insurance, more transparency in trading & settlement practices, ICICI & IDBI transformed into Banks.

## 8. CHARACTERISTICS OF FINANCIAL SERVICES:-

Intangible, Direct Sale, Heterogeneity, Fluctuation in demand, Protect Consumer Interest, Labour Intensive, Geographical dispersion, Lack of special identity, Information based, Require quality Labour.

# UNIT – 2

According to Indian Banking regulations Act 1949 "Banking is the business of accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise withdrawal by cheque, draft, order or otherwise".

## 1. FUNCTIONS OF COMMERCIAL BANKS

a) Primary functions:- Accepting deposits (Fixed, Recurring, Savings, Current); Lending money( Loans, Overdrafts, Cash Credit, Discounting of Bills);

b) Secondary Functions:- Collection of cheque & bills, Agency function, Provision of Remittance facility, Issuing letter of credit, Letter of reference, Traveller's cheque, Locker facility

c) Modern functions:- Electronic Fund Transfer(EFT), Automated Teller Machine(ATM), Credit card, Debit card, Collection of information.

## 2. Role of commercial banks in promoting economic development/IMPORTANCE OF CB'S:-

Mobilizing savings for capital formation, Financing Industry, Financing trade, Financing Agriculture, Financing Consumer Activities, Financing Employment Generation Activities, Help in monetary policy, Banks create credit, Encourage the habit of saving in the community.

3. **Modern services provided by the banks:-**

Centralised Banking solutions(CBS), On-line tax payment, Corporate Internet Banking, On-line shopping, Retail internet banking, Foreign Exchange, E-money India, On-line Railway Reservations, Depository services, Electronic Fund transfers(EFT), On-line Bill Payment, On-line Air ticket booking, On-line trading, Customer care facility.

4. **DIFFERENT BANKING INNOVATIONS:-**

Participation Certificates-PC's( certificates introduced in 1970 whereby banks could sell the loan liability to a third party either partially or in full, were very popular in 1978-79 but RBI guideline advised banks to avoid dependence on PC's and thus usage decreased since 1980)

Inter bank participations-IBP's (PC's replaced by IBP's, 2 types-one on risk sharing basis and other without it, they are confined to scheduled commercial banks including RRB, issue term 91 to 180 days, interest rate fixed is minimum 14%p.a.on IBP with risk sharing & ceiling of 12.5% p.a. on IBP without risk sharing (this ceiling was removed in 1989), issued for short term liquidity within banking system.

Consortium approach- introduced by RBI in 1974, finance given jointly by one or more banks, each consortium has a lead bank who takes maximum portion of liability and profitability carries out the regulatory formalities regarding the finance.

**Modern Services in Banking:** Internet Banking has enhanced capabilities like providing online share trading, online purchases etc., which revolutionised the banking system in the current years. The different types of modern services provided by banks through Internet Banking are–

**1. Centralised Banking Solution (CBS):** CBS, an inter-branch networking and data-sharing platform, which helps the customers to operate their accounts from any city in India having CBS Network branches, changed the status of customers from "customers of the branch" to customers of bank".

**2. Online Tax Payment**: Banks provide the facility of online payment of service tax, excise duty, custom duty and different types of charges through Internet Banking.
**3. Corporate Internet Banking**: Online funds transfer, trade, Finance management, fund management, global access, with unmatched benefits through banks corporate internet banking.
**4. Online Shopping**: This service facilitates the customers to buy gifts, send flowers, buy books and lot of activities by making payments online:
**5. Retail Internet Banking**: Internet Banking assists the customers to have an online access to bank anytime and anywhere.
**6. Foreign Exchange**: Banks have several braches authorised for handling foreign exchange business in different parts of the country.
**7. E-Money India**: Internet Banking helps the customers in sending the money to their near ones in India through E-Money services.

## 5. NEW TECHNOLOGY IN BANKING:-

Mechanization & Computerization in approach - Technology has made banking business truly international and importance being recognized by both RBI and Public sector Banks – basic computerization of public sector banks started in 1993- more than 95% banks computerized and 79.4% banks installed with CBS (Core banking Solution) – total number of branches providing CBS facility was 44,304 as on 31.3.2009 – state of art infrastructure being brought for better customer experience-shift from Queue Banking to Click Banking- development & standardization of banking software in a big way- MICR(Magnetic Ink Character Recognition) technology adopted for mechanized cheque clearance- RBI and 36 banks have become member of SWIFT for facilitating inter branch and inter bank connectivity – banks switching to Computers/LAN/WAN systems- by jaune,1996 2120 Pc's installed, 916 braches installed with LAN, 179 branches with

WAN, 937 Signature storage & 315 on-line terminal and this number is growing very fast – EFT system in place for RTGS and NEFT fund transfer – ATM installation- Credit card- internet banking.

## 6. SOURCES OF FUNDS OF COMMERCIAL BANKS:-

Paid-up Capital, Reserves and Surplus, Deposits (Current, Recurring, Savings, Fixed)
**Factors which have contributed to increase in Bank Deposits** – Increase in National Income, Increase in Number of bank Branches, Expansion of banking branches in rural areas, Introduction of various deposit schemes, Confidence of public in the banking structure, Pradhanmantri Jan Dhan yojna.

## 7. APPLICATION OF FUND OF COMMERCIAL BANKS:-

It is invested in Long Term securities, Shares, debentures, Bonds, Long term lending/loans, Medium term loans, Short term loans, Underwriting, Administrative Overheads, Expansion of banking network, Deposit with RBI in compliance of CRR norms, Investment in prescribed securities to comply with SLR requirement, etc. keeping in mind the requirement of Liquidity, Profitability and Security.

***Investment policy of Commercial banks/ Factors to be considered while application of CB's Fund –*** Liquidity, Profitability, Safety, Convertibility & Shiftability, Social consideration, Other Requirements as prescribed.

***Profitability & Liquidity Management of Commercial Bank:-***

Profitability Management – Bank has to earn sufficient profits to meet its expenditure and other overheads, safety must be kept in mind, bank belongs to shareholders who aspire for higher profit, profit increases the market value of a bank, liquidity must also be kept in mind, profitability is subject to liquidity.

Liquidity Management – Statutory regulations in place to assure liquidity, CRR and SLR must always be maintained and are strictly monitored, bank must at all time honor the demand made by any deposit holder for money and thus must maintain liquidity at all times, can't make all investment in profitable securities which are not having liquidity.

Thus, a balance to be maintained between both profitability and liquidity for smooth operations of banking.

## 8. E-BANKING : ADVANTAGES AND DISADVANTAGES/ IMPORTANCE/ SHORT NOTE :-

E-banking known as electronic banking facilitates 24 X 7 banking with electronic media. Its anywhere and anytime banking.

E-Banking includes – SPNS(Shared Payment Network System), Automated Clearing House Operation, EFT(Electronic Fund Transfer), ATM( Automated Teller machine), COMET(Computerised Message transfer), Credit Card, Debit card, Smart cards, Tele-conferencing, Video Phone, Internet banking, E-mail, fax, SWIFT(Security for World Wide Inter-bank Financial Tele Communication)

Models for E-Banking – Complete Centralised solution (CBS), Cluster Approach (each city branch connected with a regional processor which ensures connectivity amongst all regional branches), Hi-Tech banking within bank( presence of both traditional and hi-tech banking to avoid dependence on only technology)

***Advantages of E-Banking:-*** Round the clock banking, Convenient banking, Low Cost Banking Service, Profitable banking, Quality Services, Speed banking.

***Disadvantages of E-banking:-*** High-start up cost, Training and maintenance, Lack of professionals, Security, Restricted business.

## 9. DEBIT CARD-SHORT NOTES:-

Debit card also known as bank card or cheque card.

It's a plastic card having these vital information- Issuing bank Logo, EMV Chip, Hologram, Card Number, Card Brand logo, Expiration Date, Card holder's name, Helpline number and where to send this card in event if its lost.
Reverse side has- Magnetic strip, Signature strip , Card security code.

Ways in which debit card transactions are processed:- Online Debit system or PIN Debit(it requires electronic authorization by entering a unique PIN by the user and the transaction is immediately reflected in the account), Off-line debit system(these have Visa or Master card logo, at the time of transaction the payer put's his signature and they are then reflected in his account within 2 to 3 days, there is a specified limit on the transaction value), Electronic purse card system(in this the amount is stored in the card chip itself which is not connected to an account, the card itself is the payment medium)

Transactions routed through international agencies like VISA and Mastercard, Rupay debit card has also been launched and some banks are using it also.

***Importance of debit card-*** issued free of cost to customers, saves botheration from carrying cash/cheque, international market acceptability, readily accepted by retail merchant, no delay in payment as customer account debited immediately, can be used for paying petty expenses, as its withdrawal of own money no interest is charged on its use.

## 10. CREDIT CARD-SHORT NOTES:-

The issuer of card creates a revolving account for the card holder and issues a line of credit, the cardholder can withdraw money upto the specified limit through ATM or can use the card in paying designated Merchants having facility to collect payment through credit card. At the time of transaction the cardholder sign the bill of the transaction and also enters a Pin conforming the usage, some merchants have started collecting verbal authorization/electronic authorization for greater safety. Each month the credit card user is send a statement of the transactions and the total outstanding balance he is require to pay. If he pays off the balance no interest is levied else interest at a pre-specified rate which is generally high is levied till the balance is not paid.

***Benefits to customers:-*** convenient as usage doesn't depend on balance in customer's account, many benefits and discounts are offered with the usage of credit card which are not available otherwise, it's a status symbol

***Benefits to Merchant:***- It is generally more secured as payment is guaranteed by issuing banker, no cash handling required amount directly transmitted to account, increase in turnover, free advertisement.

11. **REGIONAL RURAL BANKS(RRB'S):-**

Established by Regional rural bank Act 1976, first 19 RRB's established- Increased till 196 banks but due to shortcomings gradually reduced to 82 RRB's

***Organisation:-*** One chairman appointed by Central Govt. for 5 years term generally from Supervising bank, 3 directors appointed by Central govt., 2 directors by State govt., 3 directors by Supervising bank.

RRB's are sponsored by Commercial banks- a request is made by Commercial bank to Central Govt stating its intention to establish RRB- Central Govt consults concerning state Govt. and then issues notification- one bank permitted to operate in maximum 8 districts (exception Manipur RRB which operates in entire state).

RRB's are monitored by NABARD.

**Functions of RRB's:-**

Provide loan to rural Population, Grant loan to co-operative society, Banking services, Mobilise Rural savings, Arrangement of credit, Generate employment Opportunity, Cheap supply of credit.

**Problems of RRB's:-** Haphazard Bank Expansion, Rigid Norms, Defective Recruitment policy, Weak capital base, Constraints in deposit mobilization, Erosion of profitability, Poor recovery, Defective credit deployment, High loan transaction cost.

**Suggestions for improvement :-** Merger of RRB's, Strengthening of capital structure, Government funds must be kept with RRB, Re-organised Agricultural Credit Societies, Active role of sponsor banks, Cheap re-finance to RRB, Investment in Govt. securities, Extended credit facility, Proper recovery system, Uniform scale of pay, Banking education & awareness, Wider scope of activities, Adjusted working hours.

12. **NABARD:-**

National bank for Agriculture & Rural development established on 12$^{th}$ July,1982 by Government of India by merging Agriculture Credit department of RBI, Agriculture Re-finance & development corporation, The national Agriculture Credit fund of RBI and The National Agriculture Credit (long term operation fund).

***Organisation-*** 15 member board- one chairman, one managing director, 2 experts in rural economics, 3 experts from co-operative societies and commercial banks, 3 directors from current directors of RBI, 3 directors represent Govt of India & 2 directors represent state govt.- head office Mumbai and 16 regional offices. Its apex body of all India refinance agency.

***Its resources –*** Authorised capital Rs. 500 crores and Paid up capital Rs.100 crores, - initial fund transfer from RBI at the time of set-up, borrowing from RBI, Govt. , fund from market by issue of securities and bonds, fund by govt from agencies like World Bank.

***Objectives:***- To give purposeful direction to rural development, provider of supplementary funding to rural institutions, arrangement for investment credit for various rural sectors, improve credit distribution system, provide refinance facility to CB's, RRB's for rural development, co-ordinate the working of various agencies, monitor & evaluate NABARD financed projects.

***FUNCTIONS:-***

Credit distribution (Short term, Medium term, Long term, facilities for changes & rearrangement, refinancing of industries in rural areas);

Development function(co-ordinate rural credit institutions, institution building for improving capacity of credit delivery system, to develop specialization to solve rural problems, helps other govt agencies in their rural development effort, acts as agent of govt. for monitoring, provides facilities for research & development, spreads awareness about rural banking & development, helps State govt. in subscribing for share capital of state co-operative banks, provide direct credit in approved areas, maintains easy credit aid fund);

Regulatory function (inspects the working of RRB's & co-operative banks, inspects other co-operatives also which are voluntarily financed, application for opening of branch by RRB need to be submitted to RBI through NABARD, all RRB's & co-operative banks need to submit a copy of their returns to NABARD, can obtain any information from RRB & co-operative banks)

Some recent additions to functions:-
(Farm sector)- Proper credit plans, introduction of fu;ll refinance plans, eligibility criteria for refinance of term credit liberalized, self help group schemes introduced for rural credit, interest rates rationalized, credit issued to banks for new and innovative schemes, credit development fund created.

(Non-farm sector)- Small road transport scheme introduced, Project finance for non- agro industries, Khadi & village industries brought under automatic refinance scheme, district rural industries project formulated, technical experts appointed).

**ACHIEVEMENT/ CONTRIBUTION OF NABARD IN ECONOMIC DEVELOPMENT:-**

Investment in less developed areas promoted successfully, it has become single integrated agency for rural credit needs, rehabilitation programme of central co-operative banks taken up, rural infrastructure development fund established in 1995-96, research & training to staffs rural banks, short term credit for seasonal agricultural sector, medium term finance for natural calamity, long term credit to state govt so that they can subscribe share capital of co-operative banks, implementation of externally aided projects since 1989, financial assistance to non-farm sector, re-organisation & re-establishment of RRB & co-operative banks.

13. **LEAD BANKING:-**

Lead Banking Scheme was introduced by RBI in Dec,1969. It is an important agency for credit planning- district, state and national.

***Objectives:-*** To survey potential of banking development in the given area, mobilise deposit in massive scale, increase landing to weaker sections & sectors, to make banks key local development agency, to expand banking network, to prepare District credit plan, to enhance bank finance in priority sectors.

***Responsibility:-*** Locating growth centres, assessing deposit potential, identifying credit gaps, co-ordinated credit deployment plan.

***Functions:-*** Surveying potential of banking development in given area, surveying number of industries and other establishment in given area, examining the facility for marketing of agricultural & industrial produce, surveying the facility of storage, recruitment & training of staff, assisting other primary lending agencies, maintaining liason with govt. agencies.

# UNIT – 3

A central bank, reserve bank, or monetary authority is an institution that manages a state's currency , money supply, and interest rates. As the first public bank to "offer accounts not directly convertible to coin", the Bank of Amsterdam established in 1609 is considered to be the precursor to modern central banks. The central bank of Sweden was founded in Stockholm in 1664 and answered to the parliament. Then in 1694 the Bank of England was established which laid the foundation for modern Central banks. The modern central bank evolved slowly through the 18th and 19th centuries to reach its current form.

In India the commenced its operations on 1 April 1935 during the British Rule in accordance with the provisions of the Reserve Bank of India Act, 1934. The original share capital was divided into shares of 100 each fully paid, which were initially owned entirely by private shareholders. Following India's independence on 15 - August - 1947, the RBI was nationalised on 1st January 1949.

## 1. NEED OF A CENTRAL BANK IN INDIA

To regulate the currency, to monitor the performance of general banking, act as custodian of cash reserve, manage national foreign currency reserves, to act as wholesaler of credit, to settle clearances of balance between banks, to control credit, act as a development agent.

## 2. ORGANISATIONAL STRUCTURE OF RBI

RBI IS MANAGED BY Central Board of Directors comprising of 20 members comprising of:-

i. Governor – executive head of the bank, term 5 years,appointed by Central govt.,have voting right.
ii. Maximum 4 Assistant Governors – term 5 years, appointed by Central Govt, no vote right
iii. 4 members representing 4 local boards in Metro cities appointed by Central Govt.
iv. 10 experts from various fields appointed for 4 year term appointed by Central govt.
v. 1 Govt official appointed by Central govt.-generally secretary, Ministry of finance, no vote right.

Atleast 6 meetings of Central board every year and minimum 1 meeting every quarter. Governor and assistant Governor are full time employees. Head office of RBI is in Mumbai.

4 local boards in Delhi, Mumbai, Kolkata, Chennai. Central govt. nominates five members in each board for 4 years term among whom one is elected as chairman. The manager of RBI in the region acts as ex-officio secretary of the local board.

It has 19 regional offices at most state capitals and at a few major cities in India. Few of them are located in Ahmedabad, Bangalore, Bhopal, Bhubaneswar, Chandigarh, Chennai, Delhi, Guwahati, Hyderabad, Jaipur, Jammu, Kanpur, Kolkata, Lucknow, Mumbai, Nagpur, Patna, and Thiruvananthapuram. It also has 9 sub-offices located in Samana, Dehradun, Gangtok, Kochi, Panaji, Raipur, Ranchi, Shillong, Shimla, Srinagar and Agartala .

**Departments in RBI:-** banking, Currency management, Exchange control, Industrial credit, Agricultural credit, etc.

## 3. OBJECTIVES OF RBI:-

The preamble to the RBI act states the objective as " to regulate the issue of bank notes & the keeping of reserves with a view of securing monetary stability in India & generally to operate the currency & credit system of the country to its advantage."

To manage currency & regulate foreign reserves, to institutionalize savings by promoting banking habits, build sound banking & credit structure, proper structure for agricultural credit & allied activities, proper structure for industrial finance, to lend support to planning authorities and government.

## 4. FUNCTIONS OF RBI/ CENTRAL BANK:-

i. Traditional functions:- issue of currency, banker to government, Banker's Bank, Exchange management & control, Control of Credit, Collection & Publication of data and reports, Training facilities.

ii. Promotional & Developmental functions:- Agricultural finance, Industrial finance, Export Credit, Credit to priority sector & weaker section, Bill market scheme, Development and Regulation of banking system

iii. Other Functions:- issue demand draft payable at its own offices, can borrow money from scheduled banks in event of crisis, can open account or enter into agreement with central bank of other country, purchase & sale of gold & bullion.

## 5. MONETARY POLICY OF RBI/ HOW RBI CONTROLS CREDIT?:-

i. Quantitative measures:- bank rate, Open Market Operation, Variable reserve ratio (SLR & CRR)

ii. Qualitative measures:- Rationing of credit, Direct action, Regulation of consumer credit, Margin requirements, Moral Suation, Control through directives, publicity.

6. **OBJECTIVES OF MONETARY POLICY:-** To stabilize the internal price level, to stabilize the rate of foreign exchange, to have growth with stability, to control business cycle, to control business needs, to protect the outflow of gold, full employment, to maintain equilibrium in the balance of payment(BOP).

7. **CENTRAL BANK VS. COMMERCIAL BANK:-**

i. Ownership:- Central bank with state, Comm. Bank owned by shareholders.
ii. Motive:- Central bank profit not the motive , Comm. Bank profit motive
iii. Activity :- Central do not take normal banking whereas Comm. Normal banking main activity
iv. Monetary policy :- controlled by central bank, comm. Bank controlled under this policy
v. Central bank is lender of last resort for comm. bank, whereas comm. Bank advance loan to public and accept deposit from them.
vi. Central bank do not compete with comm. Bank, comm. Bank compete with each other
vii. Central bank has statutory power Commercial bank do not have such power
viii. Central bank issue notes whereas Commercial bank cannot

# UNIT – 4

## 1. FINANCIAL MARKET – MEANING:-

Financial Markets are the centres or arrangement facilitating buying & selling of financial claims, assets, services & securities. Banking and non-banking financial institutions, dealers, borrowers & lenders, investors & savers, agents, etc are the participants on the demand and supply side in this market.

## 2. TYPES/STRUCTURE OF FINANCIAL MARKET:-

Indian Financial System divided into Money Market and Capital Market

a. **Money Market:-**
   i. Unorganised Banking Sector
   ii. Organised Banking Sector
   iii. Sub – Market {Call Money Market, Short term Bill market (Bill of Exchange & Treasury Bill), 182days treasury bill market, Certificate of deposit market, Inter Corporate Deposit Market, Commercial Paper}

b. **Capital Market:-**
   i. Gilt Edged Market
   ii. Industrial Securities Market (New Issue market, Secondary Market)
   iii. Development Financial institutions (IFCI, ICICI, IDBI, SIDBI, IRBI, UTI)
   iv. Financial Intermediaries (Merchant Bankers, Mutual Funds, Leasing Company)

Borrowing & Lending of funds in financial system can further be classified as – Industrial Finance, Agriculture Finance, Development Finance, Government Finance.

## 3. FEATURES OF INDIAN FINANCIAL SYSTEM:-

IFS plays many roles in our country, Predominance of Public Sector Undertakings, Quick transactions, Effective Competition, Sophisticated Integrated and Progressive, Reduction in transaction cost, Major Expansion in International Transactions, Controls on Administered rates relaxed.

## 4. COMPONENTS OF INDIAN FINANCIAL SYSTEM:-

a. Financial Market (Money Market, capital market-Primary & Secondary)

b. Financial Institutions-
   i. Commercial banks
   ii. Non Banking Financial Companies (NBFC) – Leasing companies, Hire purchase and consumer finance companies, Housing finance companies, Venture capital funds, Merchant banking organization, Credit rating agencies, Factoring services
   iii. Development/Public Financial Institutions
   iv. Mutual fund Institutions
   v. Insurance organizations
   vi. Foreign Private capital

c. Financial instruments – (Equity shares, Debentures, Preference shares, Innovative instruments, New debt instrument issued by companies)

d. Financial Services

## 5. MONEY MARKET – MEANING & IMPORTANCE:-

Money market refers to a mechanism whereby on the one hand borrowers manage to obtain short term funds & on the other lender succeed in getting credit worthy borrowers for their money. It is short term market for Near money instruments of a period less than one year.

Economic Development, Profitable Investment, Borrowing by the government, Importance to Central Bank, Mobilisation of fund, Helpful in self-sufficiency of commercial banks, Savings & Investment.

## 6. CHARACTERISTICS OF A DEVELOPED MONEY MARKET:-

Developed Commercial Banking system, Presence of a Central bank, Sub-market, Near money assets, Availability of ample resources, Integrated interest rate structure, Location, wholesale market, Main players.
(Indian money market is not a developed money market it is a developing money market)

## 7. NEW ISSUE MARKET/PRIMARY MARKET:-

It's a market where shares/securities are issued for the first time.

**Functions:-**

i. Facilitates transfer of resources for setting up new companies
ii. Helps in raising resources for expansion by existing companies
iii. Helps in conversion of private limited company or partnership into public limited company as going concern.

**Services provided by NIM for carrying out the above function:-**

i. Origination
ii. Underwriting
iii. Distribution

**Ways of making New issue –** Public issue through prospectus, through offer to sale, Private placement of shares, stock exchange placement of shares, Right issue, Issue of bonus shares, Book building, Stock option.

**Importance/Advantages of NIM:-** Capital formation, Liquidity, Diversification of risk, Reduction in cost, Rapid industrial growth.

**Disadvantages of NIM:-** Possibility of misguiding the investor, lack of confidence among investors, No fixed norms for project appraisal, Ineffective role of merchant bankers.

## 8. SECONDARY MARKET/STOCK EXCHANGE:-

Securities Contract (Regulation) Act 1956 defines Stock exchange as an association or orgainsation or body of individuals whether incorporated or not established for the purpose of assisting, regulating & controlling the business in buying, selling and dealing in securities.

**Features of Stock exchange:-** market for second hand securities, market for listed securities, only deal in listed securities in its exchange, is organised market, transactions can be carried by authorized members only.

**Functions of stock Exchange:-** Ready market, Safe market, Evaluation of securities, agency of capital formation, Qualitative Industrial and Commercial Development, Acting as a barometer of the company, Control over companies management, storehouse of Business information, Helpful in raising new capital, Platform for public debt.

## 9. RELATIONSHIP BETWEEN NIM & STOCK EXCHANGE:-

- Securities first pass through NIM & then enter Secondary market
- In the prospectus while making fresh issue it is mentioned that the shares will be listed in stock exchange.
- Stock exchange regulates control over NIM as a condition for getting the shares listed.
- Liquidity to shares is provided in the stock exchange to the shares which have passed through NIM
- Rising activity in stock exchange contributed to higher success ratio of NIM
- When prices are rising in stock exchange shares in NIM are issued at higher premium and vice-versa
- Stock exchange will not exist without NIM.

## 10. DIFFERENCE BETWEEN NIM & STOCK EXCHANGE:-

- NIM is for fresh shares issued first time whereas Stock exchange is for second hand shares
- NIM does not have fixed geographical location whereas stock exchange has.
- NIM raises fresh capital for companies whereas stock exchange facilitates transfer of fund from one corporate to other
- All companies enter NIM whereas only listed Companies shares are traded in stock exchange
- In NIM no tangible set up exist whereas set up of stock exchange is tangible
- NIM is subject to external control of stock exchange & SEBI whereas stock exchange is in direct control of the concerned stock exchange & SEBI.

## 11. CHARACTERISTICS OF FINANCIAL SERVICES:-

Intangible, Direct sell, Heterogeneity, Fluctuation in demand, Protect consumer interest, Labour Intensive, Geographical Dispersion, Lack of Special Identity, Information Based, Require Quality labour (Financial intermediaries/ institutions provide financial services)

## 12. MERCHANT BANKER:-

A merchant banker under SEBI Rules,1992 have been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, advisor or rendering corporate advisory services in relation to such issue management.

The first Merchant Banking service in India was started in the year 1967 by Grindlays Bank followed by Citi Bank in 1970 then SBI in 1972 followed by ICICI, Syndicate bank, PNB, etc.

Three categories of institutions carry out Merchant Bank services in India – Commercial banks, National and state Level Financial Corporations, Financial Consultancy & Management services firms.

### Services Provided/ Functions of Merchant Bankers:-

Issue management, Underwriting, Corporate Counseling, Capital structuring services, Credit syndication, Portfolio management, Non-Resident Investment, Advisory services on Merger, Arranging off shore finance, Management of fixed deposits of companies, Relief to sick industries.

## 13. UNDERWRITING:-

SEBI Rules defines underwriting as an agreement with or without consideration to subscribe the securities of body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities issued by them. In India the Companies Act,1956 limits the underwriting commission on issue of share @5% and in case of debenture @2.5% of the total issue price.

### Forms of Underwriting:-

Full Underwriting, Partial Underwriting, Joint Underwriting, Syndicate underwriting, Firm Underwriting, Sub Underwriting, Outright purchase of issue.

### Importance of underwriting:-

Increase in Goodwill of the issuing company, Service to prospective investors, Service to the society, Distribution of securities, Supply Valuable information to companies, Assurance of adequate finance

### SEBI Guidelines on Underwriting:-

- Underwriting is not mandatory,
- If issue is not underwritten and 90% of the issue is not subscribed for the amount received as must be refunded,
- if issue is underwritten and the issue is not subscribed for atleast 90% of the issue size from public subscription plus underwriting the amount received must be refunded,
- Lead manager to the issue must satisfy themselves about the Net worth of the underwriter and a stipulation of the same must be mentioned in prospectus,
- Underwriting agreement can be filed with SEBI.

**Underwriting Agencies in India:-**

Brokers, Private Investment & Insurance Companies, Commercial Banks, Development Banks and other financial institutions, Consortium Underwriting.

## 14. MARKETABLE VS. NON-MARKETABLE SECURITIES:-

**Marketable Securities:-** Government securities, Shares of listed companies, money Market Instrument (Treasury Bills, Certificate of Deposits, Inter Corporate deposits, Commercial papers, Repos)

Can be easily transferred from one person to another.

**Non-marketable Securities:-** Bank deposits, Post office saving account, Post office time deposit, Monthly income scheme of Post Office, Kisan Vikas Patra (KVP), National saving Certificate(NSC), company Deposits, Employee Provident fund scheme, public provident fund scheme.

Cannot be transferred from one person to another.