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AN OVERVIEW OF INDIAN FINANCIAL SYSTEM

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An Overview of Indian Financial System

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Abstract – Financial System of any country consists of financial markets, financial intermediation and financial instruments or financial products. This paper discusses the meaning of finance and Indian Financial System and focus on the financial markets, financial intermediaries and financial instruments. The brief review on various money market instruments are also covered in this study. India's 72% of the population lives in villages. However a significant proportion of 6,50,000 villages does not have a single bank branch leading to a financial exclusion of rural population. As Indians development, to a large extent, depends on this segments economic growth. So, it is imperative to bring the unbanked population within the ambit of banking. Invariably financially excluded people depend on money lenders even for their day-to-day needs, borrowing at exorbitant rates to finally get caught in a debt trap. On the other hand, these people are completely ignorant of financial products like Insurance, which may protect them adverse circumstances. More over the rural poor suffer from financial impediments due to their season income, irregularity of work and job related migration. In the light of such issue, the need of the hour is a financial ecosystem built to meet their living standards ensuring the growth of the economy as whole.

INTRODUCTION

The term "finance" in our simple understanding it is perceived as equivalent to 'Money'. We read about Money and banking in Economics, about Monetary Theory and Practice and about "Public Finance". But finance exactly is not money, it is the source of providing funds for a particular activity. Thus public finance does not mean the money with the Government, but it refers to sources of raising revenue for the activities and functions of a Government. Here some of the definitions of the word 'finance', both as a source and as an activity i.e. as a noun and a verb.

The American Heritage® Dictionary of the English Language, Fourth Edition defines the term as under-

- 1: "The science of the management of money and other assets.";
- 2: "The management of money, banking, investments, and credit. ";
- 3: "finances Monetary resources; funds, especially those of a government or corporate body".
- 4: "The supplying of funds or capital."

Finance as a function (i.e. verb) is defined by the same dictionary as under-

- 1: "To provide or raise the funds or capital for": financed a new car
- 2: "To supply funds to": financing a daughter through law school.
- 3: "To furnish credit to".

Another English Dictionary, "WordNet ® 1.6, © 1997Princeton University " defines the term as under-

- 1: "the commercial activity of providing funds and capital"
- 2: "the branch of economics that studies the management of money and other assets"
- 3: "the management of money and credit and banking and investments"

The same dictionary also defines the term as a function in similar words as under-

- 1: "obtain or provide money for;" "Can we finance the addition to our home?"
- 2: "sell or provide on credit"

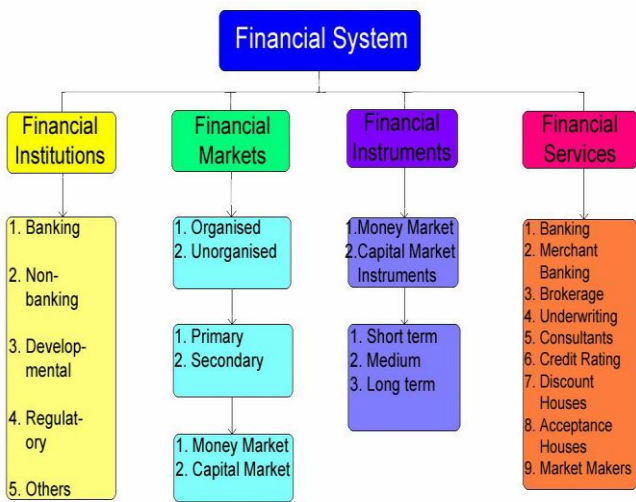
All definitions listed above refer to finance as a source of funding an activity. In this respect providing or securing finance by itself is a distinct activity or function, which results in Financial Management,

Financial Services and Financial Institutions. Finance therefore represents the resources by way funds needed for a particular activity. We thus speak of 'finance' only in relation to a proposed activity. Finance goes with commerce, business, banking etc. Finance is also referred to as "Funds" or "Capital", when referring to the financial needs of a corporate body. When we study finance as a subject for generalising its profile and attributes, we distinguish between 'personal finance' and "corporate finance" i.e. resources needed personally by an individual for his family and individual needs and resources needed by a business organization to carry on its functions intended for the achievement of its corporate goals

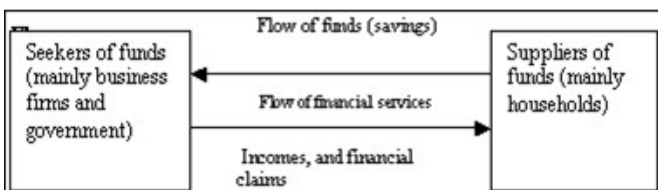
INDIAN FINANCIAL SYSTEM

The economic development of a nation is reflected by the progress of the various economic units, broadly classified into corporate sector, government and household sector. While performing their activities these units will be placed in a surplus/deficit/balanced budgetary situations. There are areas or people with surplus funds and there are those with a deficit. A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.

Financial System:



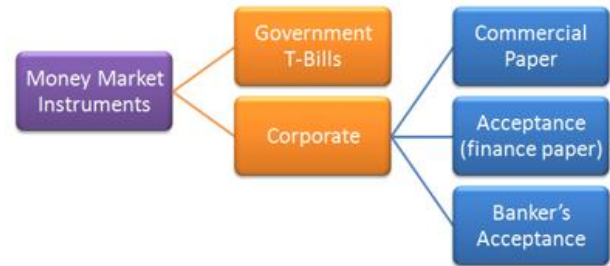
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The word "system", in the term "financial system", implies a set of complex and closely connected or interlined institutions, agents, practices, markets,

transactions, claims, and liabilities in the economy. The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other. Indian financial system consists of financial market, financial instruments and financial intermediation. These are briefly discussed below;

FINANCIAL MARKETS:



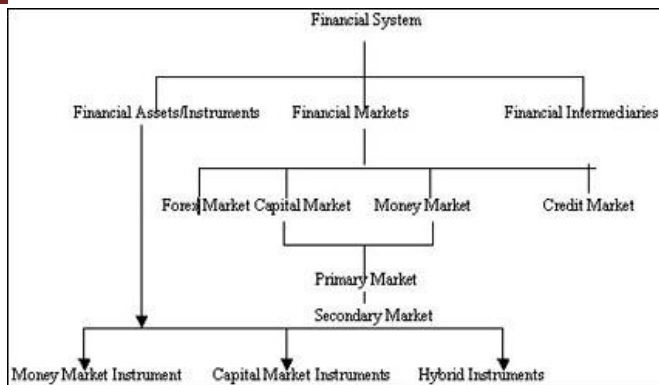
A Financial Market can be defined as the market in which financial assets are created or transferred. As against a real transaction that involves exchange of money for real goods or services, a financial transaction involves creation or transfer of a financial asset. Financial Assets or Financial Instruments represents a claim to the payment of a sum of money sometime in the future and /or periodic payment in the form of interest or dividend.

Money Market- The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.

Capital Market - The capital market is designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year.

Forex Market - The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe.

Credit Market- Credit market is a place where banks, FIs and NBFCs purvey short, medium and long-term loans to corporate and individuals.



Constituents of a Financial System

FINANCIAL INTERMEDIATION

Having designed the instrument, the issuer should then ensure that these financial assets reach the ultimate investor in order to garner the requisite amount. When the borrower of funds approaches the financial market to raise funds, mere issue of securities will not suffice. Adequate information of the issue, issuer and the security should be passed on to take place. There should be a proper channel within the financial system to ensure such transfer. To serve this purpose, **Financial intermediaries** came into existence. Financial intermediation in the organized sector is conducted by a widerange of institutions functioning under the overall surveillance of the Reserve Bank of India. In the initial stages, the role of the intermediary was mostly related to ensure transfer of funds from the lender to the borrower. This service was offered by banks, FIs, brokers, and dealers. However, as the financial system widened along with the developments taking place in the financial markets, the scope of its operations also widened. Some of the important intermediaries operating in the financial markets include; investment bankers, underwriters, stock exchanges, registrars, depositories, custodians, portfolio managers, mutual funds, financial advisers financial consultants, primary dealers, satellite dealers, self-regulatory organizations, etc. Though the markets are different, there may be a few intermediaries offering their services in more than one market e.g. underwriter. However, the services offered by them vary from one market to another.

Intermediary	Market	Role
Stock Exchange	Capital Market	Secondary Market to securities
Investment Bankers	Capital Market, Credit Market	Corporate advisory services, Issue of securities
Underwriters	Capital Market, Money Market	Subscribe to unsubscribed portion of securities
Registrars, Depositories, Custodians	Capital Market	Issue securities to the investors on behalf of the company and handle share transfer activity
Primary Dealers Satellite Dealers	Money Market	Market making in government securities
Forex Dealers	Forex Market	Ensure exchange in currencies

FINANCIAL INSTRUMENTS

Money Market Instruments

The money market can be defined as a market for short-term money and financial assets that are near substitutes for money. The term short-term means generally a period upto one year and near substitutes to money is used to denote any financial asset which can be quickly converted into money with minimum transaction cost.

Some of the important money market instruments are briefly discussed below;

1. Call/Notice Money
2. Treasury Bills
3. Term Money
4. Certificate of Deposi
5. Commercial Papers

1. Call /Notice-Money Market

Call/Notice money is the money borrowed or lent on demand for a very short period. When money is borrowed or lent for a day, it is known as Call (Overnight) Money. Intervening holidays and/or Sunday are excluded for this purpose. Thus money, borrowed on a day and repaid on the next working day, (irrespective of the number of intervening holidays) is "Call Money". When money is borrowed or lent for more than a day and up to 14 days, it is

"Notice Money". No collateral security is required to cover these transactions.

2. Inter-Bank Term Money

Inter-bank market for deposits of maturity beyond 14 days is referred to as the term money market. The entry restrictions are the same as those for Call/Notice Money except that, as per existing regulations, the specified entities are not allowed to lend beyond 14 days.

3. Treasury Bills.

Treasury Bills are short term (up to one year) borrowing instruments of the union government. It is an IOU of the Government. It is a promise by the Government to pay a stated sum after expiry of the stated period from the date of issue (14/91/182/364 days i.e. less than one year). They are issued at a discount to the face value, and on maturity the face value is paid to the holder. The rate of discount and the corresponding issue price are determined at each auction.

4. Certificate of Deposits

Certificates of Deposit (CDs) is a negotiable money market instrument issued in dematerialized form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. CDs can be issued by (i) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and (ii) select all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI. Banks have the freedom to issue CDs depending on their requirements. An FI may issue CDs within the overall umbrella limit fixed by RBI, i.e., issue of CD together with other instruments viz., term money, term deposits, commercial papers and intercorporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

5. Commercial Paper

CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt obligation is transformed into an instrument. CP is thus an unsecured promissory note privately placed with investors at a discount rate to face value determined by market forces. CP is freely negotiable by endorsement and delivery. A company shall be eligible to issue CP provided - (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crore; (b) the working capital (fund-based) limit of the company from the banking system is not less than Rs.4 crore and (c) the borrowal account of the company is classified as a Standard Asset by the financing bank/s. The minimum maturity

period of CP is 7 days. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies. (for more details visit www.indianmba.com faculty column)

CAPITAL MARKET INSTRUMENTS

The capital market generally consists of the following long term period i.e., more than one year period, financial instruments; In the equity segment Equity shares, preference shares, convertible preference shares, non-convertible preference shares etc and in the debt segment debentures, zero coupon bonds, deep discount bonds etc.

HYBRID INSTRUMENTS

Hybrid instruments have both the features of equity and debenture. This kind of instruments is called as hybrid instruments. Examples are convertible debentures, warrants etc.

CONCLUSION:

In India money market is regulated by Reserve bank of India (www.rbi.org.in) and Securities Exchange Board of India (SEBI) [www.sebi.gov.in] regulates capital market. Capital market consists of primary market and secondary market. All Initial Public Offerings comes under the primary market and all secondary market transactions deals in secondary market. Secondary market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Secondary market comprises of equity markets and the debt markets. In the secondary market transactions BSE and NSE plays a great role in exchange of capital market instruments. (visit www.bseindia.com and www.nseindia.com)

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