INDIAN FINANCIAL SYSTEM

## Introduction

The financial system of a country is an important tool for economic development of the country as it helps in the creation of wealth by linking savings with investments.

A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus 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. The 4 primary constituents of Financial Systems is as follows:

1. Financial Assets/Instruments
2. Financial Markets
3. Financial Intermediaries
4. Financial Services

## 1. Financial assets/ instruments

Financial instruments are tradable assets of any kind. They can be cash, evidence of an ownership interest in an entity, or a contractual right to receive or deliver cash or another financial instrument.

A. Money Market Instruments,

B. Capital Market Instrument,

C. Hybrid instruments

### A. 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 up to one year and near substitutes to money is used to denote any financial assets 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 Deposits,

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. 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.

**3. 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, they specified entities are not allowed to lend beyond 14 days.

**4. Certificate of Deposits:**

Certificate of Deposits (CDs) is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institutions for a specified time period. Guidelines for issue of CDs are presently governed 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. issued of CD together with other instruments viz., term money, term deposits, commercial papers and inter corporate deposits should not exceed 100% 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;

(c) The borrowable account of the company is classified as a Standard Asset by the financing banks; 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.

**B. Capital Market Instrument**

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 discounts bonds etc.

Equity Segment

1. Equity Shares:

In accounting and finance Equity is the residual claim or interest of the most junior class of investors in assets, after all liabilities are paid. If liability exceeds assets, negative equity exists. In an accounting context, shareholders' equity (or stockholder' equity, shareholders' funds, shareholders capital or similar terms) represents the remaining interest in assets of a company, spread among individual shareholders of common or preferred stock.

2. Shareholder's equity:

When the owners are shareholders, the interest can be called shareholders equity; the accounting remains the same, and it is ownership equity spread out among shareholders. If all shareholdersare in one and the same class, they share equally in ownership equity from all perspectives. However, shareholders may allow different priority ranking among themselves by the use of share classes and options. This complicates both analysis for stock valuation and accounting.

3. Market value of Shares:

In the stock market, market price per share does not correspond to the equity per share calculated in the accounting statements. Stock valuations, which are often much higher, are based on other considerations related to the business' operating cash flow, profits and future prospects; some factors are derived from the accounting statements

4. Equity in Real Estate:

The notion of equity with respect to real estate makes the equity of redemption. This equity is a property right valued at the difference between the market price of the property and the amount of any mortgage or other encumbrance.

5. Preference Shares:

Preference shares, or simply preferred, are a special equity security that has properties of both equity and a debt instrument and is generally considered a hybrid instrument. Preference Shareholders are senior (i.e. higher ranking) to common stock, but are subordinate to bonds in terms of claim or rights to their share of the assets of the company.

Preference shares usually carry no voting rights, but may carry a dividend and may have priority' over common stock in the payment of dividends and upon liquidation. Terms of the preferred stock are stated in a "Certificate of Destination". Similar to bond, preferred stocks are rated by the major credit rating companies. The rating for Preferred is generally lower since preferred dividends do not carry the same guarantees as interest payments from bonds and they are junior to all creditors.

6. Convertible Preference shares:

These shares are corporate fixed income securities that the investor can choose to turn into a certain number of shares of the company's common stock after a predetermined time span or on a specific date.

The fixed income component offers a steady income stream and some protection of the investor's capital. But the option to convert these securities into stock gives the investor the opportunity to gain from a rise in share price. Convertibles are particularly attractive to those investors who want to participate in the rise of hot growth companies while being insulated from a drop in price should the stocks not live up to expectations.

Debt segment

1. Debentures:

A debenture is a document that either creates a debt or acknowledges it, and it is debt without collateral.

In corporate finance, the term is used for a medium to long-term debt instrument used by large companies to borrow money. In some countries the term is used interchangeably with bound, loan stock or note. A debenture is thus like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest and although the money raised by the debentures becomes a part of the company's capital structure, it does not become share capital. Senior debenture gets paid before subordinate debentures, and there are varying rates and payoff for these categories. Debentures are generally freely transferable by the debenture holder.

Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the right attached to the debentures. The interest paid to them is a charge against profit in the company's financial statements.

There are two types of debentures:

1. Convertible debentures, which are convertible bonds or bonds that can be converted into equity shares of the issuing company after a predetermined period of time. "Convertibility" is a feature that corporations may add to the bonds they issue to make them more attractive to buyers. In other words, it is a special feature that a corporate bond may carry. As a result of the advantage buyer a gets from the ability to convert, convertible bonds typically have lower interest rates than non-convertible corporate bonds.

2. Non-Convertible debentures, which are simply regular debentures, cannot be converted into equity shares of the liable company. They are debentures without the convertibility feature attached to them. As a result, they usually carry higher interest rates than their convertible counterparts.

2. Zero Coupon Bonds:

A zero-coupon bond (also called a discount bond or deep discount bond) is a bond bought at a price lower than its face value, with the face value repaid at the time of maturity. It does not make periodic interest payments, or have so-called "coupons", hence the term zero-coupon bound. When the bond reaches maturity, its investor receives its par (or face) value. Examples of zero-coupon bonds include U.S. Treasury bills, U.S. Savings bonds, long-term zero-coupon bonds and any type of coupon bond that has been stripped of its coupons.

3. Deep Discount bonds:

A Bond that is selling at a discount from par value and has a coupon rate significantly less than the prevailing rates of fixed-income securities with a similar risk profile.

C. 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. Warrants: In finance, a warrant is a security that entities the holder to buy the underlying stock of the issuing company at a fixed exercise price until the expiry date.

## 2. Financial Market

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 clam to the payment of a sum of money sometime in the future and/or periodic payment in the form of interest or dividend.

Constituents of Financial Markets

The main constituents of Financial Markets are:

A. 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 a dominated mostly by government, banks and financial institutions.

B. Capital Market

Capital Market may be defined as market dealing in medium and long-term funds. It is an institutional arrangement for borrowing medium and long-term funds and which provides facilities for marketing and trading of securities. So it constitutes all long-term borrowings from banks and financial institutions, borrowings from foreign markets and raising of capital by issue various securities such as shares debentures, bonds, etc. In the present chapter let us discuss about the market for trading of securities. The market where securities are traded known as Securities market. It consists of two different segments namely primary market deals with new or fresh issue of securities and is, therefore, also known as new issue market; whereas the secondary market provides a place for purchase and sale of existing securities and is often termed as stock market or stock exchange.

i. Primary Market-

The primary market consists of arrangements, which facilitate the procurement of long term funds by companies by making fresh issue of shares and debentures. You know that companies make fresh issue of shares and/or debentures at their formation stage and, if necessary, subsequently for the expansion of business. It is usually done through private placements to friends, relatives and financial institutions or by making public issue.

ii. Secondary Market-

The secondary market known as stock market or stock exchange pays an equally important role in mobilising long-term funds by providing the necessary liquidity to holding in shares and debentures. It provides a place where these securities can be encashed without any difficulty and delay. It is an organised market where shares and debentures are traded regularly with high degree of transparency and security. In fact, an active secondary market facilitates the growth of primary market are assured of a continuous market for liquidity of their holdings. The major players in the primary market are merchant bankers, mutual funds, financial institutions and the individual investors; and in the secondary market you have all these and the stockbrokers who are members of the stock exchange who facilitate the trading.

### iii. Forex Market-

The Forex Market deals with the multicurrency requirements, which are made 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.

### iv. Credit Market

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

The main points of distinction between the primary market and secondary market are as follows:

1. Function: While the main function of primary market is to raise long-term funds through fresh issue of securities, the main function of secondary market is to provide continuous and ready market for the existing long-term securities.

2. Participants: While the major players in the primary market are financial institutions, mutual funds, underwriters and individual investors, the major players in secondary market are all of these and the stockbroker who are members of the stock exchange.

3. Listing Requirements: While only those securities can be dealt with in the secondary market, which have been approved for the purpose (listed), there is no such requirement in case of primary market.

4. Determination of prices: In case of primary market, the prices are determined by the management with due compliance with SEBI requirement for new issue of securities. But in case of secondary market.

The price of the securities is determined by force of demand and supply of the market and keeps on fluctuating.

### Functions of Financial market

a) It provides facilities for interaction between the investors and the borrowers.
b) It provides pricing information resulting from the interaction between buyers and sellers in the market when they trade the financial assets.
c) It provides security to dealings in financial assets.
d) It ensures liquidity by providing a mechanism for an investor to sell the financial assets.
e) It ensures low cost of transactions and information.

### Stock Market

A stock market or equity market is the aggregation of buyers and sellers (a loose network of economic transactions, not a physical facility or discrete entity) of stocks (also called shares); these may include securities listed on a stock exchange as well as those only traded privately.

### National Stock Exchange (NSE)

India National Stock Exchange In the year 1991 Pherwani Committee recommended to establish National Stock Exchange (NSE) in India. In 1992 the Government of India authorised IDBI for establishing this exchange. In National Stock Exchange there is trading of equity shares, bonds and government securities. India's Stock Exchanges particularly national Stock Exchange has achieved world standards in the recent years. The Index of NSE id called S&P CNX Nifty 50 (Standard & Poor's Crisil NSE Index). The value of index is calculated by taking into consideration the movement in share price and trading volume of total 50 shares.

### Bombay Stock Exchange (BSE)

Bombay Stock Exchange is one of the oldest stock exchanges in Asia was established in the year 1875 in the name of "The Native Share & Stock Brokers Association". Bombay Stock Exchange is located at Dalal Street, Mumbai, India. It got recognition in 1956 from the Government of India under securities Contracts (Regulation) Act, 1956. Presently BSE SENSEX is recognised over the world. The index of BSE is called Sensex (Sensitivity Index). The value of index is calculated by taking into consideration the movement in share price and trading volume of total 30 shares.

## 3. FINANCIAL INTERMEDIATION

Financial Intermediation is a systematic channel within the financial system to ensure the transfer of financial assets to the ultimate investor in order to garner the requisite amount. Financial intermediation in the organised sector is conducted by a wide range 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, custodian, portfolio managers, mutual funds, financial advertiser financial advertisers financial consultants, primary dealers, satellite dealers, self-regulatory organisations, etc. Through 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.

## 4. FINANCIAL SERVICES

Financial Services are concerned with the design and delivery of financial instruments, advisory services to individuals and businesses within the area of banking and related institutions, personal financial planning, leasing, investment, assets, insurance etc. These services includes

Banking Services: Includes all the operations provided by the banks including to the simple deposit and withdrawal of money to the issue of loans, credit cards etc.

Foreign Exchange services: Includes the currency exchange, foreign exchange banking or the wire transfer.

Investment Services: It generally includes the asset management, hedge fund management and the custody services.

Insurance Services: It deals with the selling of insurance policies, brokerages, insurance underwriting or the reinsurance.

Some of the other services include the advisory services, venture capital, angel investment etc.