Indian Financial System- Structure and Function

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Introduction

Financial System is a set of institutional arrangements through which financial surpluses in the economy are mobilised from surplus units and transferred to deficit spenders. The institutional arrangements include all conditions and mechanisms governing the production, distribution, exchange and holding of financial assets or instruments of all kinds and the organisations as well as the manner of operations of financial markets and institutions of all descriptions. In ancient time, the main concern of the economist seems to have been confined only to the physical aspect of development. They seems to have undervalued the role of finance in determining the pace and pattern of growth. Gurley and shaul developed the theory relating to financial system. They have argued, financial system also has a significant role in the economic development and growth of the country. They have developed a theory of finance in which they have discussed the mutual relationship between financial sector and economic development. They established positive relationship between financial system and economic development of the country. They analyse that a sound financial system is an important factor for determining the increasing rate of growth of real national products. Therefore, we can say that Economic growth and development of any country depends on a sound financial system. Financial system is a wider term and includes a set of sub-systems of financial institutions, financial markets, financial instruments and financial services. It helps in the formation of capital. It provides a framework by which savings are transformed into investments. It acts as an intermediary between savers and investors. Thus, a financial system plays a significant role in the economic growth of a country by mobilising the surplus funds and utilising them effectively for productive purposes.

Meaning of Financial System

A financial system can be defined at the global, regional of firm specific level. The firm's financial system is the set of implemented procedure that track the financial activities of the company. On a regional scale, the financial system is the system that enables lenders and borrowers to exchange funds. The global financial system is a broader regional system that encompasses all financial institutions, borrowers and lenders with global economy.

Financial system refers to the combination of financial markets, financial institutions, financial instruments and financial services. It is featured by the existence of an integrated, organized and regulated financial markets and institutions, which meet all types of financial needs of household sector as well as corporate sector. Financial markets and financial institutions play a major role in the financial system by providing various financial instruments as well as financial services to the society simultaneously.

Definitions of Financial System

According to the Van Horne, "Financial system allocate saving efficiently in an economy to ultimate users either for investment in real assets or for consumption."

According to the Prasanna Chandra, "Financial system consists of a variety of institutions, markets and instruments related in a systematic manner and provide the principal means by which savings are transformed into investments."

Role of Indian Financial System

A sound financial system is a necessity for the economic development and growth of the country. A financial system performs the following functions for the economic development and growth of the country:

- Financial system mobilise the savings and investment of the society into productive activities. It helps in transforming savings into investments.
- It provides money and monetary assets for the production of goods and services. Monetary assets are those assets that can be converted into cash or in terms of money easily without loss of value.

- It also provides protection against life, health and income risks. These guarantees are accomplished through the sale of life, health and property insurance policies.
- It helps in the selection of projects to be financed and review the performance of such project periodically.
- It promotes the process of capital formation by mobilising the saving and investments of the society.
- It provides a framework for the transfer of resources across geographic boundaries.
- It assists in reducing the transactions costs and increasing the returns on investments.
- It provides valuable information at right time to the people involved in the market. This helps people in taking the advantage of opportunity and minimising the risk involved in any transaction.
- It provides a payment mechanism for the exchange of goods and services.

From the above, we can say that a financial system is the backbone of the country without which a country cannot move on the way of development and growth. A financial system indirectly creates employment opportunities for the stressed youth. It also increases the standard of living of the society. In brief, it is the soul of a nation. Without it, a nation cannot progress.

Thus, there are three main constituents of financial system:

(a) Financial Assets

(b) Financial Markets, and

(c) Financial Institutions.

Financial assets are subdivided under two heads:

Primary securities and secondary securities. The former are financial claims against real-sector units, for example, bills, bonds, equities etc. They are created by real-sector units as ultimate borrowers for raising funds to finance their deficit spending. The secondary securities are financial claims issued by financial institutions or intermediaries against themselves to raise funds from public. For examples, bank deposits, life insurance policies, UTI units, IDBI bonds etc.

Functions of Financial System:

The financial system helps production, capital accumulation, and growth by (i) encouraging savings, (ii) mobilising them, and (iii) allocating them among alternative uses and users. Each of these functions is important and the efficiency of a given financial system depends on how well it performs each of these functions.

(i) Encourage Savings:

Financial system promotes savings by providing a wide array of financial assets as stores of value aided by the services of financial markets and intermediaries of various kinds. For wealth holders, all this offers ample choice of portfolios with attractive combinations of income, safety and yield.

With financial progress and innovations in financial technology, the scope of portfolio choice has also improved. Therefore, it is widely held that the savings-income ratio is directly related to both financial assets and financial institutions. That is, financial progress generally insures larger savings out of the same level of real income.

As stores of value, financial assets command certain advantages over tangible assets (physical capital, inventories of goods, etc.) they are convenient to hold, or easily storable, more liquid, that is more easily encashable, more easily divisible, and less risky.

A very important property of financial assets is that they do not require regular management of the kind most tangible assets do. The financial assets have made possible the separation of ultimate ownership and management of tangible assets. The separation of savings from management has encouraged savings greatly.

Savings are done by households, businesses, and government. Following the official classification adopted by the Central Statistical Organization (CSO), Government of India, we reclassify savers into—household sector, domestic private corporate sector, and the public sector.

The household sector is defined to comprise individuals, non-Government, non-corporate entities in agriculture, trade and industry, and non-profit making organisations like trusts and charitable and religious institutions.

The public sector comprises Central and state governments, departmental and non departmental undertakings, the RBI, etc. The domestic private corporate sector comprises non-government public and private limited companies (whether financial or non-financial) and corrective institutions.

Of these three sectors, the dominant saver is the household sector, followed by the domestic private corporate sector. The contribution of the public sector to total net domestic savings is relatively small.

(ii) Mobilisation of Savings:

Financial system is a highly efficient mechanism for mobilising savings. In a fully-monetised economy this is done automatically when, in the first instance, the public holds its savings in the form of money. However, this is not the only way of instantaneous mobilisation of savings.

Other financial methods used are deductions at source of the contributions to provident fund and other savings schemes. More generally, mobilisation of savings taken place when savers move into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, bill, bonds, equity shares, etc.

(iii) Allocation of Funds:

Another important function of a financial system is to arrange smooth, efficient, and socially equitable allocation of credit. With modem financial development and new financial assets, institutions and markets have come to be organised, which are replaying an increasingly important role in the provision of credit.

In the allocative functions of financial institutions lies their main source of power. By granting easy and cheap credit to particular firms, they can shift outward the resource constraint of these firms and make them grow faster.

On the other hand, by denying adequate credit on reasonable terms to other firms, financial institutions can restrict the growth or even normal working of these other firms substantially. Thus, the power of credit can be used highly discriminately to favour some and to hinder others.

Structure of Indian Financial System:

Financial system operates through financial markets and institutions.

The Indian Financial system (financial markets) is broadly divided under two heads:

(i) Indian Money Market

(ii) Indian Capital Market

The Indian money market is the market in which short-term funds are borrowed and lent. The money market does not deal in cash, or money but in bills of exchange, grade bills and treasury bills and other instruments. The capital market in India on the other hand is the market for the medium term and long term funds.

Overview of Indian Financial System

Growth of financial sector is a sign of the economic development of the country. The new economic policy in 1991 brings a massive change in the Indian financial system. Let us have a look at the changes occurred in the Indian financial system. These changes can be studied into three stages:

- Pre-independence
- Post-independence to Before the announcement of New Economic Policy in 1991
- After the announcement of New Economic Policy in 1991

Pre-Independence Stage

Before independence, the Indian financial system was unorganised. The stock exchanges had a very few industrial securities being traded in the market. There is a lack of an institution that can separately perform the functions of issuing the securities prevailing in the market. Financial intermediaries had no interest in participating for the long term financing of industries. Industries have to depend on their own funds. Industries access to outside savings was restricted at that time. In brief we can say that Indian financial system before independence was not able of achieving high rate if industrial and economic growth. It was very far from the growth of new and innovating enterprises at that time.

Post-Independence to before the announcement of New Economic Policy in 1991

After independence, the main emphasis was on planned economic development. A scheme of planned economic development was evolved in 1951 for achieving the economic as well as social objectives of the country. Indian Constitution also laid emphasis on achieving economic growth with social justice. As a result first five-year plan was introduced in 1951.

At the beginning of this stage, the main thrust was to transfer the ownership from private to public sector and set up new enterprise in the public sector. The transfer of ownership from private to public sector began when Reserve Bank was nationalised through Reserve Bank (Transfer of Public Ownership) Act, 1948. In 1948, Reserve Bank had undertaken a detailed study to find out the need of specialized institutions. In 1948, the first development bank IFCI was established. Parliament passed State Financial Corporation Act. The act permits the state government could establish financial corporations for their respective regions. At present, there are 18 SFC's in India. In first five-year plan, All India Rural Credit Survey Committee, 1951 criticised the working of the Imperial Bank in its report and suggested the setting up of a State Bank by taking over the Imperial Bank of India and other State Associate Banks. In 1954, National Industrial Development Corporations (NIDC) was established with the objective of promoting industries in the countries. State Bank of India established on July 1, 1955 by accepting the suggestion of AIRCSC.

The Industrial Credit and Investment Corporation of India Ltd. (ICICI) was established in 1955 as a Joint Stock Company. In 1956, the nationalization of 245 life insurance companies took place. As a result, Life Insurance Corporation of India came into existence on 1st September 1956 as a statutory institution incorporated under the LIC Act, 1956. RBI, LIC and Commercial Banks established Refinance Corporation for Industry Ltd. (RCI) in 1958. Unit Trust of India (UTI) and Industrial Development Bank of India (IDBI) was established in 1964. RCI was merged with IDBI. IDBI was a wholly owned subsidiary of RBI. Industrial Reconstruction Corporation of India Ltd. (RCI) was set up in 1971 for the rehabilitation of sick units.

For achieving public control on private financial institutions, 14 commercial banks with a deposit base of Rs. 50 crores or more were nationalised in 1969. In 1972, General Insurance Corporation came into existence by passing the General Insurance Business (Nationalisation) Act, 1972. Six more private sector banks were nationalised in 1980. Now the total number of nationalised banks was twenty. National Bank for Agriculture and Rural Development (NABARD) was set up in 1982 for providing short-term, medium-term and long-term finance to agriculture and allied activities. Export-Import Bank of India (EXIM Bank) was established for providing financial assistance to exporters and importers.

In short, we can say that after independence there was a positive change in the Indian financial system. A large number of institutions were set up for the development of the country and for meeting the financial needs of all types of users.

After the announcement of New Economic Policy in 1991

Indian financial system has changed after the announcement of new economic policy in 1991. Liberlisation, Privatisation and Globalisation (LPG) have changed Indian economy from closed to open economy. Financial system is now focusing more attention on the development of capital market that is evolving as the main agency for the allocation of resources among public sector, private sector and state government.

After 1991, government control over financial institutions has diluted. Public financial institutions have been transformed into companies. Government has allowed private sector to enter into banking and insurance sector. There is a remarkable change in the activities of Development Finance Institutions (DFIs). DFIs are engaged in non-fund based financial activities such as merchant banking, project counseling and portfolio management services. It raised funds through the issue of bonds. It has promoting a large number of financial institutions. In the beginning, UTI was the single organization issuing the mutual fund units. Now mutual funds are also sponsored by banks, insurance organization, FIIS, private sector. Minimum investment in mutual fund units has been increased from Rs. 1000 to Rs. 5000 in primary market. Mutual funds industry shows a positive change after the announcement of new economic policy.

Securities and Exchange Board of India (SEBI) was established by passing the SEBI Act, 1992 for protecting interest of investors, promoting the development of securities market and for regulating the securities market. There is a tremendous change in the secondary market. There is regulation of badla trading. National Stock Exchange and Over The Counter Exchange of India is established. Setting up of National Securities Depository Ltd. and Central Depository Services (India) Ltd. and system of electronic trading through dematerialistion of shares etc. has taken place.

The Unit Trust of India has been split into two parts because of the repeal of the UTI Act. GIC has been delinked from its four subsidiaries. Introduction of derivatives trading has also been a significant development having implications on the financial system. The merger of the ICICI Ltd. and IDBI into ICICI Bank and IDBI Bank respectively is also a significant impact on financial system.

Conclusion

After a brief study about the Indian financial system, we can conclude that Indian financial system changed a lot periodically. Before independence, it is under developed and not organised. There was a very few investor. There was a very few industrial securities being traded in the market. After independence, government control has increased. Because of increased government control, nationalisation of 245 life insurance companies took place in 1956. There was again nationalistion of 14 commercial banks and 6 commercial banks took place in 1969 and 1980 respectively. After the announcement of new economic policy, private sector comes into existence. Public sector companies are transferred in the hands of private sector by the mode of disinvestment. SEBI came into existence in 1992 for protecting the investors and regulating the securities market. National Stock Exchange and Over The Counter Exchange of India was set up in this period. The shares have been dematerialized and electronic trading system has come into the market. Right to Information Act, 2005 and Companies Act (Amended), 2013 also have impact on the Indian financial system. Overall changes occur in the Indian financial system plays a vital role in the economic development and growth of the country.

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