

UNIT 1: OVERVIEW OF FINANCIAL SYSTEM

An introduction to the financial system, Overview of financial system, Functions of a financial system.

Evolution of financial systems (capital market oriented) Financial systems in India compared with those in developed nations and developing nations Constituents of the financial system and interrelationships between various components

UNIT-1

OVERVIEW OF INDIAN FINANCIAL SYSTEM

Meaning of Indian financial system

A financial system is a set of institutions and practices that facilitate and allow for the exchange of funds between borrowers, lenders and investors. The financial system enables lenders and borrowers to exchange funds. India has a financial system that is controlled by independent regulators in the sectors of insurance, banking, capital markets and various services sectors. Thus, a financial system can be said to play a significant role in the economic growth of a country by mobilizing the surplus funds and utilizing them effectively for productive purposes.

The Indian financial system is a complex network of financial institutions, markets, instruments, and services that facilitate the flow of funds between savers and investors. It comprises of various entities such as banks, non-banking financial companies (NBFCs), insurance companies, stock exchanges, mutual funds, pension funds, and other financial intermediaries

DEFINITIONS

According to Gurusamy

Financial System is "a set of complex and closely interconnected financial institutions, markets, instruments, services, practises, and transactions."

According to Amit Chaudhary,

"Financial system is the integrated form of financial institutions, financial markets, financial securities and financial services which aim is to circulate the funds in an economy for economic growth."

According to AMC,

"Financial system is the set of interrelated and interconnected components consisting financial institutions, markets and securities."

FUNCTIONS OF INDIAN FINANCIAL SYSTEM

The Indian financial system has several functions that help to meet the financial needs of individuals and businesses. Here are some of the key functions of the Indian financial system:

Mobilization of Savings: The Indian financial system helps to mobilize savings from various sectors of the economy and channel them towards productive investments. This is achieved through various financial intermediaries such as banks, mutual funds, and insurance companies.

Allocation of Credit: The Indian financial system also plays a key role in allocating credit to different sectors of the economy. Banks and other financial institutions provide loans and credit facilities to businesses and individuals to help them meet their financial needs.

Payment System: The financial system provides a safe and efficient payment mechanism to facilitate transactions between different individuals and businesses. This is achieved through various payment systems such as NEFT, RTGS, and IMPS.

Risk Management: The financial system helps to manage risks associated with financial transactions. Financial intermediaries such as insurance companies provide risk management products such as life insurance, health insurance, and property insurance.

Price Discovery: The Indian financial system also helps in the discovery of prices of financial assets such as stocks, bonds, and commodities. This is achieved through various financial intermediaries such as stock exchanges and commodity exchanges.

Economic Development: The financial system plays a critical role in the economic development of the country. It provides financial resources for investment in infrastructure, industries, and other productive sectors of the economy.

Financial Inclusion: The Indian financial system also strives to promote financial inclusion by providing access to financial services to individuals and businesses in remote and underdeveloped areas of the country

EVOLUTION OF FINANCIAL SYSTEM

History of Indian financial system dates back even before the period when India got independence in the Year 1947. Evolution of Indian Financial system can be classified into 3 phases: –

- I. Pre Independence Phase (Before 1947).
- II. Post-Independence Phase (1947-1991).
- III. The Liberalization Era (1991 and beyond).

I. PRE- INDEPENDENCE PHASE (BEFORE 1947).

- ii. The first bank of India was the “*Bank of Hindustan*”, established in 1770 and located in the then Indian capital, Calcutta. However, this bank failed to work and ceased operations in 1832.
- iii. During the Pre Independence period over 600 banks had been registered in the country, but only a few managed to survive.
- iv. Following the path of Bank of Hindustan, various other banks were established in India. They were:
 - The General Bank of India (1786-1791)
 - Oudh Commercial Bank (1881-1958)

- Bank of Bengal (1809)
 - Bank of Bombay (1840)
 - Bank of Madras (1843)
- V. During the British rule in India, The East India Company had established three banks: Bank of Bengal, Bank of Bombay and Bank of Madras and called them the Presidential Banks. These three banks were later merged into one single bank in 1921, which was called the “*Imperial Bank of India.*”
- VI. The Imperial Bank of India was later nationalised in 1955 and was named The State Bank of India, which is currently the largest Public sector Bank.

Pre-Independence Banks in India	
Bank Name	Year of Establishment
Allahabad Bank	1865
Punjab National Bank	1894
Bank of India	1906
Central Bank of India	1911
Canara Bank	1906
Bank of Baroda	1908

II. POST INDEPENDENCE PERIOD (1947-1991)

At the time when India got independence, all the major banks of the country were led privately which was a cause of concern as the people belonging to rural areas were still dependent on money lenders for financial assistance.

With an aim to solve this problem, the then Government decided to nationalise the Banks. These banks were nationalised under the Banking Regulation Act, 1949. Whereas, the Reserve Bank of India was nationalised in 1949.

Following it was the formation of State Bank of India in 1955 and the other 14 banks were nationalised between the time duration of 1969 to 1991. These were the banks whose national deposits were more than 50 crores.

Given below is the list of these 14 Banks nationalised in 1969:

1. Allahabad Bank
2. Bank of India
3. Bank of Baroda
4. Bank of Maharashtra
5. Central Bank of India
6. Canara Bank
7. Dena Bank
8. Indian Overseas Bank
9. Indian Bank
10. Punjab National Bank
11. Syndicate Bank
12. Union Bank of India
13. United Bank
14. UCO Bank

In the year 1980, another 6 banks were nationalised, taking the number to 20 banks. These banks included:

1. Andhra Bank
2. Corporation Bank
3. New Bank of India
4. Oriental Bank of Comm.
5. Punjab & Sind Bank
6. Vijaya Bank

Apart from the above mentioned 20 banks, there were seven subsidiaries of SBI which were nationalised in 1959:

1. State Bank of Patiala
2. State Bank of Hyderabad
3. State Bank of Bikaner & Jaipur
4. State Bank of Mysore
5. State Bank of Travancore
6. State Bank of Saurashtra
7. State Bank of Indore

All these banks were later merged with the State Bank of India in 2017, except for the State Bank of Saurashtra, which merged in 2008 and State Bank of Indore, which merged in 2010.

The Regional Rural Banks in India were established in the year 1975 for the development of rural areas in India.

III.LIBERALISATION PERIOD (1991-TILL DATE)

- a. To provide stability and profitability to the Nationalised Public sector Banks, the Government decided to set up a committee under the leadership of Shri. M Narasimham to manage the various reforms in the

Indian banking industry. During this period, government opened up the economy ,with the introduction of NEP-1991 popular as LPG-Liberalisation, Privatisation & Globalisation

- b. The biggest development was the introduction of Private sector banks in India. RBI gave license to 10 Private sector banks to establish themselves in the country. These banks included:
 1. Global Trust Bank
 2. ICICI Bank
 3. HDFC Bank
 4. Axis Bank
 5. Bank of Punjab
 6. IndusInd Bank
 7. Centurion Bank
 8. IDBI Bank
 9. Times Bank
 10. Development Credit Bank
- c. In 1992 National Stock Exchange Established to provide fully automated electronic trading
- d. Credit Rating Agencies – Credit Rating Information Services of India Limited(CRISIL),Investment Information and Credit Rating Agency Limited (ICRA), and Credit Analysis & Research Limited(CARE) were established.
- e. Between 1991 and 2021, India has seen the creation of several new regulators—
 - a. Securities and Exchange Board of India in 1992;
 - b. Telecom Regulatory Authority of India in 1997; Insurance Regulatory
 - c. Development Authority of India in 1999;
 - d. Competition Commission of India in 2002;
 - e. Pension Fund Regulatory and Development Authority of India in 2003.
 - f. OTCEI was incorporated in 1990 under the Companies Act 1956.

COMPONENTS/ CONSTITUENTS OF INDIAN FINANCIAL SYSTEM

The following are the four major components that comprise the Indian Financial System:

1. Financial Markets
2. Financial Institutions
3. Financial Instruments/ Assets/ Securities
4. Financial Services.

- **FINANCIAL MARKETS:**

Financial markets are the environments where buyers and sellers interact with one another to purchase, trade and sell assets like bonds and shares. These markets include trading houses, such as the New York Stock Exchange and NASDAQ. It is through financial markets and institutions that the financial system of an economic works. Financial markets refer to the institutional

arrangements for dealing in financial assets and credit instruments of different types such as currency, cheques, bank deposits, bills, bonds etc. These organised markets can be further classified into two they are

- Capital Market
- Money Market

CAPITAL MARKET

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three namely:

1. Industrial securities market
2. Government securities market
3. Long term loans market

MONEY MARKET:

It is the marketplace where the short term securities.(Maturity is less than a year), like treasury bills, Repo, commercial papers etc are issued and traded (sold & purchased) over the counter among people.

- **FINANCIAL INSTITUTIONS:**

Financial institutions, such as banks, provide a range of products and services and act as a mediator between borrowers and investors. They offer services like mortgages, brokerage accessibility and insurance. They help mobilize savings directly or indirectly and raise funds for financial assets like loans, securities and deposits.

Financial institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return.

TYPES OF FINANCIAL INSTITUTIONS

Financial institutions can be classified into two categories:

A. Banking Institutions

B. Non - Banking Financial Institutions

A. BANKING INSTITUTIONS (Reserve Bank of India)

Indian banking industry is subject to the control of the Central Bank. The RBI as the apex institution organises, runs, supervises, regulates and develops the monetary system and the financial system of the country. The main legislation governing commercial banks in India is the Banking Regulation Act, 1949. The Indian banking institutions can be broadly classified into two categories:

1. Organised Sector
2. Unorganised Sector.

1. Organised Sector

- (a) Commercial Banks: The commercial banks may be scheduled banks or non – scheduled banks.
- (b) Co-operative banks: The segment is represented by a group of societies registered under the Acts of the states relating to cooperative societies. In fact, co-operative societies may be credit societies or non-credit societies.
- (c) Regional Rural Banks (RRBs): Regional Rural Banks were set by the state government and sponsoring commercial banks with the objective of developing the rural economy. Regional rural banks provide banking services and credit to small farmers, small entrepreneurs in the rural areas.
- (d) Foreign Banks: Foreign banks have been in India from British days. Foreign banks as banks that have branches in the other countries and main Head Quarter in the Home Country. With the deregulation (Elimination of Government Authority) in 1993, a number of foreign banks are entering India. Foreign Banks are: Citi Bank. Bank of Ceylon.

2. Unorganised Sector.

1. Indigenous Bankers Indigenous Bankers are private firms or individual who operate as banks and as such both receive deposits and given loans. Like bankers, they also financial intermediaries. They should be distinguished professional money lenders whose primary business is not banking and money lending. The indigenous banks are trading with the Hundies, Commercial Paper.

2. Money Lenders: Money lenders depend entirely to on their one funds. Money Lenders may be rural or urban, professional or non-professional. They include large number of farmer, merchants, traders. Their operations are entirely unregulated. They charge very high rate of interest.

B. NON – BANKING INSTITUTIONS

1. Development Finance Institutions.

These include: The institutions like IDBT, ICICI, IFCI, IIBI, IRDC at all India level. The State Finance Corporations (SFCs), State Industrial Development Corporations (SIDCs) at the state level. Agriculture Development Finance Institutions as NABARD, LDBS etc. Development banks provide medium and long term finance to the corporate and industrial sector and also take up promotional activities for economic development

2. Investment Institutions.

These include those financial institutions which mobilise savings at the public at large through various schemes and invest these funds in corporate and government securities. These include LIC, GIC, LTT, and mutual funds

- **FINANCIAL INSTRUMENTS OR FINANCIAL ASSETS:**

Financial instruments or assets are the products traded in financial markets, such as securities, stocks, bonds, insurance and mortgages. There may be different requirements for each credit

seeker, and trading stocks or securities may involve mutual funds or pooling the savings of investors.

Financial securities can be classified into:

- (i) Primary or direct securities.
- (ii) Secondary or indirect securities.

Primary Securities

These are securities directly issued by the ultimate investors to the ultimate savers. Eg. shares and debentures issued directly to the public.

Secondary Securities

These are securities issued by some intermediaries called financial intermediaries to the ultimate savers. Eg. Unit Trust of India and mutual funds issue securities in the form of units to the public and the money pooled is invested in companies.

• FINANCIAL SERVICES:

Financial services are the services provided by liability and asset management companies, such as investment, insurance and banking services. These services help acquire and efficiently invest funds. Financial services provided by various financial institutions, commercial banks and merchant bankers can be broadly classified into two categories.

1. ASSET BASED/FUND BASED SERVICES.

- Lease Financing
- Hire Purchase and Consumer Credit
- Insurance Services

2. FEE BASED/ADVISORY SERVICES.

- Merchant Banking
- Credit Rating
- Stock – Broking
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CHALLENGES IN INDIAN FINANCIAL SYSTEM

1. The rise of Non-Performing Assets (NPAs), including bad loans or problems in the agricultural and corporate sectors. Currently, the country's NPAs have crossed 10 lakh crores, with more than 70% being from the corporate sector.
2. The increasing number of frauds, including accounting fraud, demand draft fraud, uninsured deposits, fraudulent loans, and others. The RBI in 2022 reported total fraud cases of around 9103, the biggest being the PNB scam of 11,000 crores, Vijay Mallya defaulting lenders for Rs. 9000 crores, and several others that we have witnessed recently.
3. Lack of banking for the underserved and rural population, which is approximately 69% of India's total population. Around 1.4 billion Indians do not have access to formal banking, as per the World Bank report.
4. Lack of reach in rural areas, where technical enablement and use of financial services remain a big challenge..
5. **Rising Customer Demands:** Evolving customer expectations will always be part of the challenges faced by the financial system sector, but it's important to note that ever-changing customer demographics is the key driver to these heightened expectations. With each new

generation of customers comes a more innate understanding of technology, and, as a result, an increased expectation of digitized experiences

6. **Customer Retention and Loyalty** :A single transaction has the potential to create a lasting impression on how the customer identifies with the brand or retailer. A study on the impact of customer service on customer lifetime value shows that 97% of respondents stopped buying from a company after experiencing poor interaction with customer support⁴. Since the majority of a business' revenue comes from repeat buyers, companies should definitely consider maintaining customer loyalty as one of the key financial system challenges to focus on.
7. **Increased Competition in the Era of FinTech** :Competition isn't something new in the list of financial system industry challenges. What concerns many financial institutions today is the rapid growth of FinTech startups. Meanwhile, organizations will want to learn from FinTechs that owe their success to providing simplified and intuitive customer experiences. Finding ways to exceed customer expectations and stand out from the competition are one of the key financial system industry challenges to focus on.
8. **Data Breaches and Cybersecurity Issues** :One of the major problems of financial system sector concerns data privacy and cybersecurity. According to an annual survey by Allianz Risk Barometer, cybersecurity incidents maintains its position as the top risk for financial system companies⁶. Financial system deal with sensitive and personal data, making them a prime target for cybercriminals. As employees continue to shift to remote work, millions of finance workers are handling confidential financial documents in less secure home environments, increasing their vulnerability to cyberattackers.
9. **Technology's Unprecedented Pace** :Technology is key to solving the many challenges faced by financial system sector so it might be surprising to hear that it's also posing some valid concerns among industry leaders. In another PwC survey, 70% of the surveyed CEOs said the speed of change in technology was concerning⁷. From artificial intelligence (AI)-powered wearables that monitor a person's vital stats to self-driving cars, technology has become fully ingrained in our culture. Soon enough, there won't be any room left for manual processes or systems and those who do not embrace digital transformation will be ultimately left behind.
10. **Maintaining Regulatory Compliance** :Regulatory compliance is more important than ever in 2022. Ever since organizations emerged from the global pandemic, regulatory enforcement has become even stricter across industries⁸. Organizations must anticipate regulatory compliance requirements and policies to continue to heighten in the future. This is why maintaining regulatory compliance remains as one of the major problems of financial system sector today.

FINANCIAL SYSTEM IN INDIA IN COMPARISON WITH OTHER NATIONS

Financial systems in the various countries can be of Bank Based Financial System or Market Based Financial System In Bank Based Financial Systems, banks play a leading role in mobilising savings, allocating capital, overseeing investment decisions. In Market Based Financial System, securities market share centre stage with banks in terms of getting society's savings to firms, exerting control. Indian Financial System is bank based like Germany & Japan, American and British system are Market Based Financial system