As per New CBCS Syllabus for First Semester, B.Com, Bangalore University w.e.f. 2014-15

Indian Financial System

- E. Gordon
- K. Natarajan

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As per New Syllabus (CBCS) for First Semester, B.Com., Bangalore University w.e.f. 2014-15)

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PREFACE

Encouraged by the warm welcome accorded to our previous edition of the book **"INDIAN FINANCIAL SYSTEM"**, we have pleasure in presenting this edition in the hands of our academic community. This present edition is intended to serve primarily as a standard textbook for the new syllabus of the B.Com. Degree course in the University of Bangalore.

The distinguishing feature of this book is that it provides a thorough treatment of allied topics relating to the Indian Financial System as mentioned in the syllabus. To provide a complete understanding of the subject matter, 'gaps' in the syllabus have been duly filled by adding appropriate topics in a synthetic order in the entire framework of the textbook. All the topics have been analytically discussed, along with the latest statistical information from authentic sources in a fairly self-contained manner. Utmost care has been taken to provide a lucid exposition and clarity of the subject matter at all stages. Above all, it is comprehensive, as well as self-explanatory.

We are greatly indebted to all our well-wishers and academic friends for their constant encouragement, youthful inspiration and concrete suggestions. Our publishers deserve special thanks for their wholehearted support and cooperation in bringing out this revised edition elegantly and in time.

Critical comments and constructive suggestions for the improvement of the text for the next edition will be gratefully appreciated and acknowledged.

SIVAKASI
01-06-2015

E. Gordon
K. Natarajan

SYLLABUS

OBJECTIVE

The objective of this subject is to familiarise the students with regard to structure, organisation and working of financial system in India.

Unit 1: Financial System **12 hours**

Introduction – Meaning – Classification of Financial System. Financial Markets – Functions and Significance of Primary Market, Secondary Market, Capital Market and Money Market.

Unit 2: Financial Institutions **14 hours**

Types of Banking and Non-banking Financial Institutions. Constitution, Objectives and Functions of IDBI, SFCs, SIDCs, LIC, EXIM Bank. Mutual Funds – Features and Types.

Unit 3: Commercial Banks **10 hours**

Introduction – Role of Commercial Banks – Functions of Commercial Banks – Primary Functions and Secondary Functions – Investment Policy of Commercial Banks. Narasimaham Committee Report on Banking Sector Reforms.

Unit 4: Regulatory Institutions **10 hours**

Reseve Bank of India (RBI)– Organisation – Objectives – Role and Functions. The Securities Exchange Board of India (SEBI)– Organisation and Objectives.

Unit 5: Financial Services **10 hours**

Meaning and Definition – Features – Importance. Types of Financial Services – Factoring, Leasing, Venture Capital, Consumer Finance – Housing and Vehicle Finance.

SKILL DEVELOPMENT

- Draft a chart showing the financial services in the Indian Financial System.
- List the Instruments traded in the Financial Markets.
- Draft the application forms for opening a Fixed, Current and Savings Bank Accounts.
- Collection and recording of Foreign Exchange rates of different currencies *vis-a-vis* Rupee.
- Specimen of Debit and Credit cards.
- Specimen of Cheque with MICR technology.

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CHAPTER

1

THE FINANCIAL SYSTEM IN INDIA

Introduction

The economic development of any country depends upon the existence of a well organised financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promote the well-being and standard of living of the people of a country. **Thus, the 'financial system' is a broader term which brings under its fold the financial markets and the financial institutions which support the system.** The major assets traded in the financial system are money and monetary assets. The responsibility of the financial system is to mobilise the savings in the form of money and monetary assets and invest them to productive ventures. An efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development.

FUNCTIONS OF THE FINANCIAL SYSTEM

1. Provision of Liquidity

The major function of the financial system is the provision of money and monetary assets for the production of goods and services. There should not be any shortage of money for productive ventures. In financial language, the money and monetary assets are referred to as liquidity. The term liquidity refers to cash or money and other assets which can be converted into cash readily without loss. Hence, all activities in a financial system are related to liquidity – either provision of liquidity or trading in liquidity. In fact, in India the RBI has been vested with the monopoly power of issuing coins and currency notes. Commercial banks can also create cash (deposit) in the form of 'credit creation' and other financial institutions also deal in monetary assets. Over supply of money is also dangerous to the economy. In India the RBI is the leader of the financial system and hence it has to control the money supply and creation of credit by banks and regulate all the financial institutions in the country in the best interest of the nation. It has to shoulder the responsibility of developing a sound financial system by strengthening the institutional structure and by promoting savings and investment in the country.

2. Mobilisation of Savings

Another important activity of the financial system is to mobilise savings and channelise them into productive activities. The financial system should offer appropriate incentives to attract savings and make them available for more productive ventures. Thus, the financial system facilitates the transformation of saving into investment and consumption. The financial intermediaries have to play a dominant role in this activity.

3. Size Transformation Function

Generally, the savings of millions of small investors are in the nature of a small unit of capital which cannot find any fruitful avenue for investment unless it is transformed into a perceptible size of credit unit. Banks and other financial intermediaries perform this size transformation function by collecting deposits from a vast majority of small customers and giving them as loan of a sizeable quantity. Thus, this size transformation function is considered to be one of the very important functions of the financial system.

4. Maturity Transformation Function

Another important function of the financial system is the maturity transformation function. The financial intermediaries accept deposits from public in different maturities according to their liquidity preference and lend them to the borrowers in different maturities according to their need and promote the economic activities of a country.

5. Risk Transformation Function

Most of the small investors are risk-averse with their small holding of savings. So, they hesitate to invest directly in stock market. On the other hand, the financial intermediaries collect the savings from individual savers and distribute them over different investment units with their high knowledge and expertise. Thus, the risks of individual investors get distributed. This risk transformation function promotes industrial development. Moreover, various risk mitigating tools are available in the financial system like hedging, insurance, use of derivatives, etc.

Financial Concepts

An understanding of the financial system requires an understanding of the following concepts:

(i) Financial assets

(ii) Financial intermediaries

(iii) Financial markets

(iv) Financial rates of return

(v) Financial instruments

(I) FINANCIAL ASSETS

In any financial transaction, there should be a creation or transfer of financial asset. Hence, the basic product of any financial system is the financial asset. A financial asset is one which is used for production or consumption or for further creation of assets. For instance, A buys equity shares and these shares are financial assets since they earn income in future.

In this context, one must know the distinction between financial assets and physical assets. Unlike financial assets, physical assets are not useful for further production of goods or for earning income. For example, X purchases land and buildings, or gold and silver. These are physical assets since they cannot be used for further production. Many physical assets are useful for consumption only.

It is interesting to note that the objective of investment decides the nature of the asset. For instance, if a building is bought for residential purposes, it becomes a physical asset. If the same is bought for hiring, it becomes a financial asset.

Classification of Financial Assets

Financial assets can be classified differently under different circumstances. One such classification is:

(i) Marketable assets

(ii) Non-marketable assets

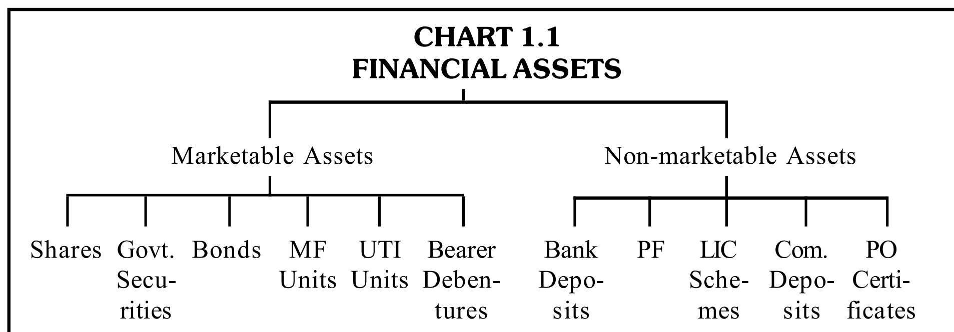
Marketable Assets

Marketable assets are those which can be easily transferred from one person to another without much hindrance. Examples: Shares of Listed Companies, Government Securities, Bonds of Public Sector Undertakings, etc.

Non-marketable Assets

On the other hand, if the assets cannot be transferred easily, they come under this category. *Examples:* Bank Deposits, Provident Funds, Pension Funds, National Savings Certificates, Insurance Policies, etc. This classification is shown in the following Chart 1.1.

CHART 1.1
FINANCIAL ASSETS



Yet another classification is as follows:

(i) Money or cash asset

(ii) Debt asset

(iii) Stock asset

Cash Asset

In India, all coins and currency notes are issued by the RBI and the Ministry of Finance, Government of India. Besides, commercial banks can also create money by means of creating credit. When loans are sanctioned, liquid cash is not granted. Instead an account is opened in the borrower's name and a deposit is created. It is also a kind of money asset.

Debt Asset

Debt asset is issued by a variety of organisations for the purpose of raising their debt capital. Debt capital entails a fixed repayment schedule with regard to interest and principal. There are different ways of raising debt capital. Example: Issue of debentures, raising of term loans, working capital advance, etc.

Stock Asset

Stock is issued by business organisations for the purpose of raising their fixed capital. There are two types of stock namely – equity and preference. Equity shareholders are the real owners of the business and they enjoy the fruits of ownership and at the same time they bear the risks as well. Preference shareholders, on the other hand get a fixed rate of dividend (as in the case of debt asset) and at the same time they retain some characteristics of equity.

(II) FINANCIAL INTERMEDIARIES

The term financial intermediary includes all kinds of organisations which intermediate and facilitate financial transactions of both individuals and corporate customers. Thus, it refers to all kinds of financial institutions and investing institutions which facilitate financial transactions in financial markets. They may be in the organised sector or in the unorganised sector. They may also be classified into two:

(i) Capital market intermediaries

(ii) Money market intermediaries

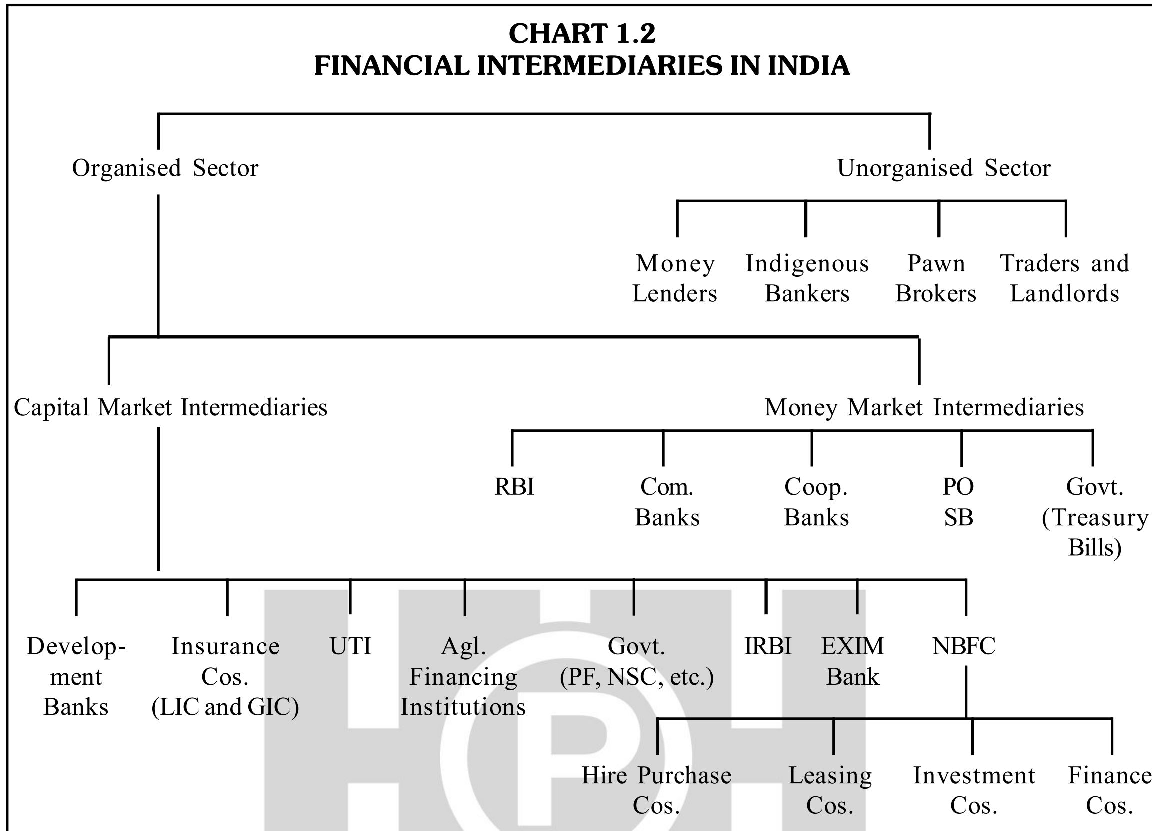
Capital Market Intermediaries

These intermediaries mainly provide long-term funds to individuals and corporate customers. They consist of term lending institutions like financial corporations and investing institutions like LIC.

Money Market Intermediaries

Money market intermediaries supply only short-term funds to individuals and corporate customers. They consist of commercial banks, cooperative banks, etc. The classification of financial intermediaries is displayed in Chart 1.2.

CHART 1.2
FINANCIAL INTERMEDIARIES IN INDIA



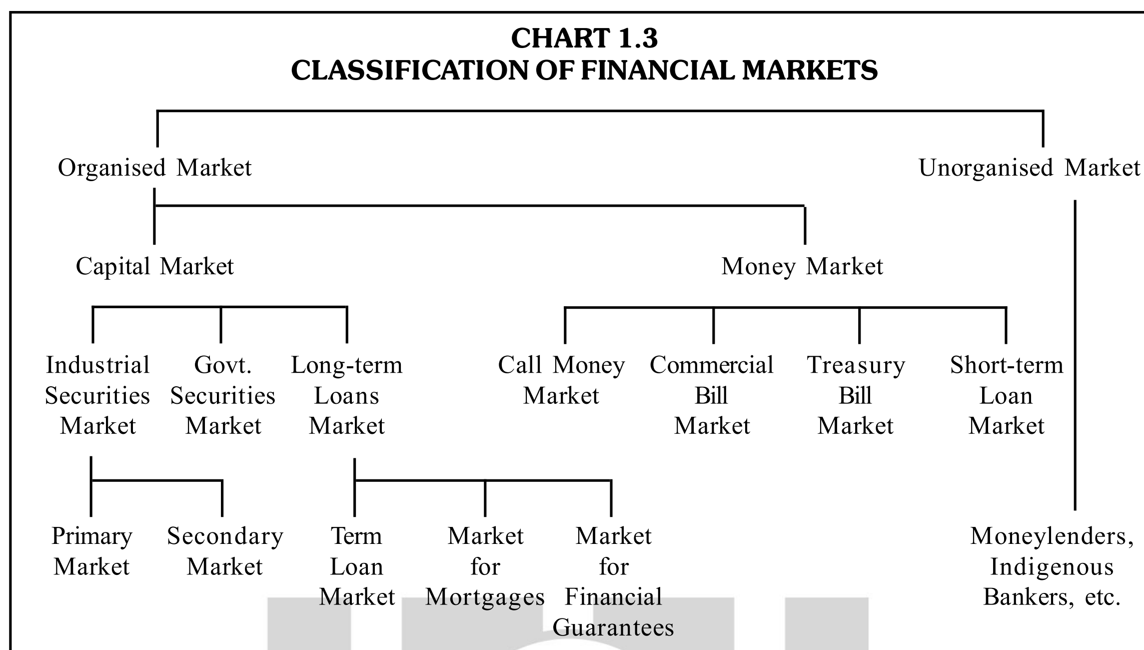
(III) FINANCIAL MARKETS

Generally speaking, there is no specific place or location to indicate a financial market. Wherever a financial transaction takes place, it is deemed to have taken place in the financial market. Hence, financial markets are pervasive in nature since financial transactions are themselves very pervasive throughout the economic system. For instance, issue of equity shares, granting of loan by term lending institutions, deposit of money into a bank, purchase of debentures, sale of shares and so on.

However, financial markets can be referred to as those centres and arrangements which facilitate buying and selling of financial assets, claims and services. Sometimes, we do find the existence of a specific place or location for a financial market as in the case of stock exchange.

Classification of Financial Markets

The classification of financial markets in India is shown in Chart 1.3.



Unorganised Markets

In these markets there are a number of moneylenders, indigenous bankers, traders, etc., who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds, etc., whose activities are not controlled by the RBI. Recently the RBI has taken steps to bring private finance companies and chit funds under its strict control by issuing non-banking financial companies (Reserve Bank) Directions, 1998. The RBI has already taken some steps to bring the unorganised sector under the organised fold. They have not been successful. The regulations concerning their financial dealings are still inadequate and their financial instruments have not been standardised.

Organised Markets

In the organised markets, there are standardised rules and regulations governing their financial dealings. There is also a high degree of institutionalisation and instrumentalisation. These markets are subject to strict supervision and control by the RBI or other regulatory bodies.

These organised markets can be further classified into two. They are:

(i) Capital market

(ii) 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:

(i) Industrial securities market

(ii) Government securities market, and

(iii) Long-term loans market

I. Industrial Securities Market

As the very name implies, it is a market for industrial securities namely: (i) Equity shares or ordinary shares, (ii) Preference shares, and (iii) Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are:

(i) Primary market or New issue market, and

(ii) Secondary market or Stock exchange

Primary Market

Primary market is a market for new issues or new financial claims. Hence, it is also called New issue market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, the primary market facilitates capital formation.

There are three ways by which a company may raise capital in a primary market. They are:

(i) Public issue

(ii) Rights issue

(iii) Private placement

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

Secondary Market

Secondary market is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the Stock Exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognised by the Government of India. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act, 1956. The Bombay Stock Exchange is the principal stock exchange in India which sets the tone of the other stock markets.

II. Government Securities Market

It is otherwise called Gilt-edged Securities Market. It is a market where Government Securities are traded. In India, there are many kinds of Government Securities – short-term and long-term. Long-

term securities are traded in this market while short-term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi-government authorities like City Corporations, Port Trusts, etc. Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in this market.

Government Securities are issued in denominations of ₹ 100. Interest is payable half-yearly and they carry tax exemptions also. The role of brokers in marketing these securities is practically very limited and the major participant in this market is the “commercial banks” because they hold a very substantial portion of these securities to satisfy their SLR requirements.

The secondary market for these securities is very narrow since most of the institutional investors tend to retain these securities until maturity.

The Government Securities are in many forms. These are generally:

(i) Stock certificates or inscribed stock

(ii) Promissory notes

(iii) Bearer Bonds which can be discounted.

Government Securities are sold through the Public Debt Office of the RBI, while Treasury Bills (short-term securities) are sold through auctions.

Government Securities offer a good source of raising inexpensive finance for the Government exchequer and the interest on these securities influences the prices and yields in this market. Hence, this market also plays a vital role in monetary management.

III. Long-term Loans Market

Development banks and commercial banks play a significant role in this market by supplying long-term loans to corporate customers. Long-term loans market may further be classified into:

(a) Term loans market

(b) Mortgages market

(c) Financial Guarantees market

(a) Term Loans Market

In India, many industrial financing institutions have been created by the Government both at the national and regional levels to supply long-term and medium-term loans to corporate customers directly as well as indirectly. These development banks dominate the industrial finance in India. Institutions like IDBI, IFCI, ICICI, and other state financial corporations come under this category. These institutions meet the growing and varied long-term financial requirements of industries by supplying long-term loans. They also help in identifying investment opportunities, encourage new entrepreneurs and support modernisation efforts.

(b) Mortgages Market

The mortgages market refers to those centres which supply mortgage loan mainly to individual customers. A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage. This mortgage may be equitable mortgage or legal one. Again it may be a first charge or second charge. Equitable mortgage is created by a mere deposit of title deeds to properties as security, whereas in the case of a legal mortgage the title in the property is legally transferred to the lender by the borrower. Legal mortgage is less risky.

Similarly, in the first charge, the mortgager transfers his interest in the specific property to the mortgagee as security. When the property in question is already mortgaged once to another creditor, it becomes a second charge when it is subsequently mortgaged to somebody else. The mortgagee can also further transfer his interest in the mortgaged property to another. In such a case, it is called a sub-mortgage.

The mortgage market may have primary market as well as secondary market. The primary market consists of original extension of credit and secondary market has sales and resales of existing mortgages at prevailing prices.

In India residential mortgages are the most common ones. The Housing and Urban Development Corporation (HUDCO) and the LIC play a dominant role in financing residential projects. Besides, the Land Development Banks provide cheap mortgage loans for the development of lands, purchase of equipment, etc. These development banks raise finance through the sale of debentures which are treated as trustee securities.

(c) Financial Guarantees Market

A guarantee market is a centre where finance is provided against the guarantee of a reputed person in the financial circle. Guarantee is a contract to discharge the liability of a third party in case of his default. Guarantee acts as a security from the creditor's point of view. In case the borrower fails to repay the loan, the liability falls on the shoulders of the guarantor. Hence, the guarantor must be known to both the borrower and the lender and he must have the means to discharge his liability.

Though there are many types of guarantees, the common forms are: (i) Performance Guarantee, and (ii) Financial Guarantee. Performance guarantees cover the payment of earnest money, retention money, advance payments, non-completion of contracts, etc. On the other hand financial guarantees cover only financial contracts.

In India, the market for financial guarantees is well organised. The financial guarantees in India relate to:

(i) Deferred payments for imports and exports

(ii) Medium and long-term loans raised abroad

(iii) Loans advanced by banks and other financial institutions.

These guarantees are provided mainly by commercial banks, development banks, Governments both Central and States and other specialised guarantee institutions like ECGC (Export Credit Guarantee Corporation) and DICGC (Deposit Insurance and Credit Guarantee Corporation). This guarantee financial service is available to both individual and corporate customers. For a smooth functioning of any financial system, this guarantee service is absolutely essential.

IMPORTANCE OF CAPITAL MARKET

Absence of capital market acts as a deterrent factor to capital formation and economic growth. Resources would remain idle if finances are not funneled through capital market. The importance of capital market can be briefly summarised as follows:

(i) The capital market serves as an important source for the **productive use of the economy's savings**. It mobilises the savings of the people for further investment, and thus avoids their wastage in unproductive uses.

(ii) It provides **incentives to saving** and facilitates capital formation by offering suitable rates of interest as the price of capital.

(iii) It provides an **avenue for investors**, particularly the household sectors to invest in financial assets which are more productive than physical assets.

(iv) It facilitates **increase in production and productivity** in the economy and thus enhances the economic welfare of the society. Thus, it facilitates "the movement of stream of command over capital to the point of highest yield" towards those who can apply them productively and profitably to enhance the national income in the aggregate.

(v) The operations of different institutions in the capital market **induce economic growth**. They give quantitative and qualitative directions to the flow of funds and bring about rational allocation of scarce resources.

(vi) A healthy capital market consisting of expert intermediaries promotes **stability in values of securities** representing capital funds.

(vii) Moreover, it serves as an important source for **technological upgradation** in the industrial sector by utilising the funds invested by the public.

Thus, a capital market serves as an important link between those who save and those who aspire to invest these savings.

MONEY MARKET

Money market is a market for short-term loans or financial assets. It is a market for the lending and borrowing of short-term funds. As the name implies, it does not actually deal in cash or money. But it actually deals with near substitutes for money or near money like trade bills, promissory notes and Government Papers drawn for a short period not exceeding one year. These short-term instruments can be converted into cash readily without any loss and at low transaction cost.

Money market is the centre for dealing mainly in short-term money assets. It meets the short-term requirements of borrowers and provides liquidity or cash to lenders. It is the place where short-term surplus funds at the disposal of financial institutions and individuals are borrowed by individuals, institutions and also the Government.

The money market does not refer to a particular place where short-term funds are dealt with. It includes all individuals, institutions and intermediaries dealing with short-term funds. The transactions between borrowers, lenders and middlemen take place through telephone, telegraph, mail and agents. No personal contact or presence of the two parties is essential for negotiations in a money market. However, a geographical name may be given to a money market according to its location. For example, the London money market operates from Lambard Street and the New York money market operates from Wall Street. But, they attract funds from all over the world to be lent to borrowers from all over the globe. Similarly, the Bombay money market is the centre for short-term loanable funds of not only Bombay, but also the whole of India.

Definition

According to Geottery Crowther, "The money market is the collective name given to the various firms and institutions that deal in the various grades of near money".

Money Market vs. Capital Market

In this context, it is imperative that one should know the distinction between a money market and a capital market. The distinction is briefly shown in the following table:

Money Market	*Capital Market*
(i) It is a market for short-term loanable funds for a period of not exceeding one year	(i) It is a market for long-term funds exceeding a period of one year
(ii) This market supplies funds for financing current business operations, working capital requirements of industries and short period requirements of the government	(ii) This market supplies funds for financing the fixed capital requirements of trade and commerce as well as the long-term requirements of the government
(iii) The instruments that are dealt in a money market are bills of exchange, treasury bills, commercial papers, certificate of deposit, etc.	(iii) This market deals in instruments like shares, debentures, Government bonds, etc.
(iv) Each single money market instrument is of large amount. A TB is of minimum for one lakh. Each CD or CP is for a minimum of ₹ 25 lakh.	(iv) Each single capital market instrument is of small amount. Each share value is ₹ 10. Each debenture value is ₹ 100.
(v) The Central bank and Commercial banks are the major institutions in the money market.	(v) Development banks and Insurance companies play a dominant role in the capital market.
(vi) Money market instruments generally do not have secondary markets.	(vi) Capital market instruments generally have secondary markets.

(vii) Transactions mostly take place over-the-phone and there is no formal place.	(vii) Transactions take place at a formal place, *viz.,* stock exchange.
(viii) Transactions have to be conducted without the help of brokers.	(viii) Transactions have to be conducted only through authorised dealers.

Features of a Money Market

The following are the general features of a money market:

(i) It is a market purely for short-term funds or financial assets called near money.

(ii) It deals with financial assets having a maturity period up to one year only.

(iii) It deals with only those assets which can be converted into cash readily without loss and with minimum transaction cost.

(iv) Generally, transactions take place through phone, i.e., oral communication. Relevant documents and written communications can be exchanged subsequently. There is no formal place like stock exchange as in the case of a capital market.

(v) Transactions have to be conducted without the help of brokers.

(vi) It is not a single homogeneous market. It comprises of several submarkets, each specialising in a particular type of financing. E.g., Call money market, Acceptance market, Bill market and so on.

(vii) The components of a money market are the Central Bank, Commercial Banks, Non-banking financial companies, discount houses and acceptance houses. Commercial banks generally play a dominant role in this market.

Objectives

The following are the important objectives of a money market:

(i) To provide a parking place to employ short-term surplus funds, mainly of commercial banks.

(ii) To provide room for overcoming short-term deficits.

(iii) To enable the central bank to influence and regulate liquidity in the economy through its intervention in this market.

(iv) To provide a reasonable access to users of short-term funds to meet their requirements quickly, adequately and at reasonable costs.

CHARACTERISTIC FEATURES OF A DEVELOPED MONEY MARKET

In order to fulfil the above objectives, the money market should be fully developed and efficient. In every country of the world, some type of money market exists. Some of them are highly developed while others are not well developed. Prof. S. N. Sen has described certain essential features of a developed money market. They are as follows:

(i) Highly Organised Banking System

The commercial banks are the nerve centre of the whole money market. They are the principal suppliers of short-term funds. Their policies regarding loans and advances have impact on the entire money market. The commercial banks serve as a vital link between the central bank and the various segments of the money market. Consequently, a well developed money market and a highly organised banking system coexist. In an underdeveloped money market, the commercial banking system is not fully developed.

(ii) Presence of a Central Bank

The central bank acts as the banker's bank. It keeps their cash reserves and provides them financial accommodation in times of difficulties by discounting their eligible securities. In other words, it enables the commercial banks and other institutions to convert their assets into cash in times of financial crisis. Through its open market operations, the central bank absorbs surplus cash during off-seasons and provides additional liquidity in the busy seasons. Thus, the central bank is the leader, guide and controller of the money market. In an underdeveloped money market, the central bank is in its infancy and not in a position to influence and control the money market.

(iii) Availability of Proper Credit Instruments

A developed money market requires a continuous availability of readily acceptable negotiable securities such as bills of exchange, treasury bills, etc., in the market. There should be a number of dealers in the money market to transact in these securities. Availability of negotiable securities and the presence of dealers and brokers in large numbers to transact in these securities are needed for the existence of a developed money market. There is absence of adequate and proper credit instruments as well as dealers to deal in these instruments in an underdeveloped money market.

(iv) Existence of Submarkets

The number of submarkets determines the development of a money market. The larger the number of submarkets, the broader and more developed will be the structure of money market. The several submarkets together make a coherent money market. In an underdeveloped money market, the various submarkets, particularly the bill market, are absent. Even if submarkets exist, there is no co-ordination between them. Consequently, different money rates prevail in the submarkets and they remain unconnected with one another.

(v) Ample Resources

There must be availability of sufficient funds to finance transactions in the submarkets. These funds may come from within the country and also from foreign countries. The London, New York and Paris money markets attract funds from all over the world. The underdeveloped money markets are starved of funds.

(vi) Existence of Secondary Market

There should be an active secondary market in these instruments.

(vii) Demand and Supply of Funds

There should be a large demand and supply of short-term funds. It presupposes the existence of a large domestic and foreign trade. Besides, it should have adequate amount of liquidity in the form of large amounts maturing within a short period.

Other Factors

Besides the above, other factors also contribute to the development of a money market. Rapid industrial development leading to the emergence of stock exchanges, large volume of international trade leading to the system of bills of exchange, political stability, favourable conditions for foreign investment, price stabilisation, etc., are the other factors that facilitate the development of money market in the country.

London Money Market is a highly developed money market because it satisfies all requirements of a developed money market.

If any one or more of these factors are absent, then the money market is called an underdeveloped one.

IMPORTANCE OF MONEY MARKET

A developed money market plays an important role in the financial system of a country by supplying short-term funds adequately and quickly to trade and industry. The money market is an integral part of a country's economy. Therefore, a developed money market is highly indispensable for the rapid development of the economy. A developed money market helps the smooth functioning of the financial system in any economy in the following ways:

(i) Development of Trade and Industry

Money market is an important source of financing trade and industry. The money market, through discounting operations and commercial papers, finances the short-term working capital requirements of trade and industry and facilitates the development of industry and trade both – national and international.

(ii) Development of Capital Market

The short-term rates of interest and the conditions that prevail in the money market influence the long-term interest as well as the resource mobilisation in capital market. Hence, the development of capital market depends upon the existence of a developed money market.

(iii) Smooth Functioning of Commercial Banks

The money market provides the commercial banks with facilities for temporarily employing their surplus funds in easily realisable assets. The banks can get back the funds quickly, in times of need, by resorting to the money market. The commercial banks gain immensely by economising on their cash balances in hand and at the same time meeting the demand for large withdrawal of their depositors. It also enables commercial banks to meet their statutory requirements of cash reserve ratio (CRR) and Statutory Liquidity Ratio (SLR) by utilising the money market mechanism.

(iv) Effective Central Bank Control

A developed money market helps the effective functioning of a central bank. It facilitates effective implementation of the monetary policy of a central bank. The central bank, through the money market, pumps new money into the economy in slump and siphons it off in boom. The central bank, thus, regulates the flow of money so as to promote economic growth with stability.

(v) Formulation of Suitable Monetary Policy

Conditions prevailing in a money market serve as a true indicator of the monetary state of an economy. Hence, it serves as a guide to the government in formulating and revising the monetary policy then and there depending upon the monetary conditions prevailing in the market.

(vi) Non-inflationary source of Finance to Government

A developed money market helps the government to raise short-term funds through the treasury bills floated in the market. In the absence of a developed money market, the government would be forced to print and issue more money or borrow from the central bank. Both ways would lead to an increase in prices and the consequent inflationary trend in the economy.

Composition of Money Market

The money market may be subdivided into four. They are:

(i) Call money market

(ii) Commercial bills market

(iii) Treasury bills market

(iv) Short-term loan market.

(i) Call Money Market

The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on demand at the option of either the lender or the borrower. In India, call money markets are associated with the presence of stock exchanges and hence, they are located in major industrial towns like Bombay, Calcutta, Chennai, Delhi, Ahmedabad, etc. The special feature of this market is that the interest rate varies from day to day and even from hour to hour and centre to centre. It is very sensitive to changes in demand and supply of call loans.

(ii) Commercial Bills Market

It is a market for Bills of Exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill promising to pay at a later date specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

In India the bill market is underdeveloped. The RBI has taken many steps to develop a sound bill market. The RBI has enlarged the list of participants in the bill market. The Discount and Finance House of India was set-up in 1988 to promote secondary market in bills. In spite of all these, the

growth of the bill market is slow in India. There are no specialised agencies for discounting bills. The commercial banks play a significant role in this market.

(iii) Treasury Bills Market

It is a market for treasury bills which have 'short-term' maturity. A treasury bill is a promissory note or a finance bill issued by the government. It is highly liquid because its repayment is guaranteed by the government. It is an important instrument for short-term borrowing of the government. There are two types of treasury bills namely: (i) ordinary or regular, and (ii) *ad hoc* treasury bills popularly known as *'ad hocs'*.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short-term financial needs. *Ad hoc* treasury bills are issued in favour of the RBI only. They are not sold through tender or auction. They can be purchased by the RBI only. *Ad hocs* are not marketable in India but holders of these bills can sell them back to RBI. Treasury bills have a maturity period of 91 days or 182 days or 364 days only. Financial intermediaries can park their temporary surpluses in these instruments and earn income.

(iv) Short-term Loan Market

It is a market where short-term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market. Commercial banks provide short-term loans in the form of cash credit and overdraft. Overdraft facility is mainly given to business people whereas cash credit is given to industrialists. Overdraft is purely a temporary accommodation and it is given in the current account itself. But cash credit is for a period of one year and it is sanctioned in a separate account.

FOREIGN EXCHANGE MARKET

The term foreign exchange refers to the process of converting home currencies into foreign currencies and *vice versa*. According to Dr. Paul Einzing "Foreign exchange is the system or process of converting one national currency into another, and of transferring money from one country to another".

The market where foreign exchange transactions take place is called a foreign exchange market. It does not refer to a marketplace in the physical sense of the term. In fact, it consists of a number of dealers, banks and brokers engaged in the business of buying and selling foreign exchange. It also includes the central bank of each country and the treasury authorities who enter into this market as controlling authorities. Those engaged in the foreign exchange business are controlled by the Foreign Exchange Maintenance Act.

Functions

The most important functions of this market are:

(i) To make necessary arrangements to **transfer purchasing power** from one country to another.

(ii) **To provide adequate credit facilities** for the promotion of foreign trade.

(iii) **To cover foreign exchange** risks by providing hedging facilities.

In India, the foreign exchange business has a three-tiered structure consisting of:

(i) Trading between banks and their commercial customers.

(ii) Trading between banks through authorised brokers.

(iii) Trading with banks abroad.

(V) FINANCIAL INSTRUMENTS

Financial instruments refer to those documents which represent financial claims on assets. As discussed earlier, financial asset refers to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend. *Examples:* Bill of exchange, Promissory Note, Treasury Bill, Government Bond, Deposit receipt, Share, Debenture, etc. The innovative instruments introduced in India have been discussed later in the chapter 'Financial Services'.

Financial instruments can also be called financial securities.

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. E.g., shares and debentures issued directly to the public.

Secondary Securities

These are securities issued by some intermediaries called financial intermediaries to the ultimate savers. E.g., 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.

Again these securities may be classified on the basis of duration as follows:

(i) Short-term securities

(ii) Medium-term securities

(iii) Long-term securities.

Short-term securities are those which mature within a period of one year. E.g., Bill of Exchange, Treasury bill, etc. Medium-term securities are those which have a maturity period ranging between one and five years. E.g., Debentures maturing within a period of 5 years. Long-term securities are those which have a maturity period of more than five years. E.g., Government Bonds maturing after 10 years.

Characteristics Features of Financial Instruments

Generally speaking, financial instruments possess the following characteristic features:

(i) Most of the instruments can be **easily transferred** from one hand to another without many cumbersome formalities.

(ii) They have a **ready market**, i.e., they can be bought and sold frequently and thus trading in these securities is made possible.

(iii) They **possess liquidity**, i.e., some instruments can be converted into cash readily. For instance, a bill of exchange can be converted into cash readily by means of discounting and rediscounting.

(iv) Most of the securities **possess security value**, i.e., they can be given as security for the purpose of raising loans.

(v) Some securities **enjoy tax status**, i.e., investments in these securities are exempted from Income Tax, Wealth Tax, etc., subject to certain limits. E.g., Public Sector Tax free Bonds, Magnum Tax Saving Certificates.

(vi) They carry risk in the sense **that there is uncertainty** with regard to payment of principal or interest or dividend as the case may be.

(vii) These instruments **facilitate futures trading** so as to cover risks due to price fluctuations, interest rate fluctuations, etc.

(viii) These instruments involve **less handling costs** since expenses involved in buying and selling these securities are generally much less.

(ix) The **return on these instruments is directly in proportion** to the risk undertaken.

(x) These instruments may be **short-term or medium-term or long-term** depending upon the maturity period of these instruments.

DEVELOPMENT OF FINANCIAL SYSTEM IN INDIA

Some serious attention was paid to the development of a sound financial system in India only after the launching of the planning era in the country. At the time of Independence in 1947, there was no strong financial institutional mechanism in the country. There was absence of issuing institutions and non-participation of intermediary financial institutions. The industrial sector also had no access to the savings of the community. The capital market was very primitive and shy. The private as well as the unorganised sector played a key role in the provision of 'liquidity'. On the whole, chaotic conditions prevailed in the system.

With the adoption of the theory of mixed economy, the development of the financial system took a different turn so as to fulfil the socioeconomic and political objectives. The government started creating new financial institutions to supply finance both for agricultural and industrial development and it also progressively started nationalising some important financial institutions so that the flow of finance might be in the right direction.

Nationalisation of Financial Institutions

As stated earlier the RBI is the leader of the financial system. But, it was established as a private institution in 1935. It was nationalised in 1948. It was followed by the nationalisation of the Imperial Bank of India in 1955 by renaming it as State Bank of India. In the same year, 245 Life Insurance Companies were brought under government control by merging all of them into a single corporation called Life Insurance Corporation of India. Another significant development in our financial system was the nationalisation of 14 major commercial banks in 1969. Again, six banks were nationalised in 1980. This process was then extended to General Insurance Companies which were reorganised under the name of General Insurance Corporation of India. Thus, the important financial institutions were brought under public control.

Starting of Unit Trust of India

Another landmark in the history of development of our financial system is the establishment of new financial institutions to strengthen our system and to supply institutional credit to industries.

The Unit Trust of India was established in 1964 as a public sector institution to collect the savings of the people and make them available for productive ventures. It is the oldest and largest mutual fund in India. It is governed by its own statutes and regulations. However, since 1994, the schemes of UTI have to be approved by the SEBI. It has introduced a number of open-ended and close-ended schemes. It also provides repurchase facility of units of the various income schemes after a minimum lock-in period of one year. Some of the unit schemes of UTI are linked with stock exchanges. Its investment is confined to both corporate and non-corporate sectors. In recent years it has established the following subsidiaries:

(i) The UTI Bank Ltd., in April 1994.

(ii) The UTI Investor Service Ltd., to act as UTI's own Registrar and Transfer agency.

(iii) The UTI Security Exchange Ltd.

Establishment of Development Banks

Many development banks were started not only to extend credit facilities to financial institutions but also to render advisory services. These banks are multipurpose institutions which provide medium and long-term credit to industrial undertakings, discover investment projects, undertake the preparation of project reports, provide technical advice and managerial services and assist in the management of industrial units. These institutions are intended to develop backward regions as well as small and new entrepreneurs.

The Industrial Finance Corporation of India (IFCI) was set-up in 1948 with the object of "making medium- and long-term credits more readily available to industrial concerns in India, particularly under circumstances where normal banking accommodation is inappropriate or recourse to capital issue method is impracticable". At the regional level, State Financial Corporations were established under the State Financial Corporation Act, 1951 with a view to providing medium- and long-term finance to medium and small industries. It was followed by the establishment of the Industrial Credit and Investment

Corporation of India (ICICI) in 1955 to develop large and medium industries in private sector, on the initiative of the World Bank. It adopted a more dynamic and modern approach in industrial financing. Now, it has been merged with the ICICI bank. Subsequently, the Government of India set-up the Refinance Corporation of India (RCI) in 1958 with a view to providing refinance facilities to banks against term loans granted by them to medium and small units. Later on it was merged with the Industrial Development Bank of India.

The Industrial Development Bank of India (IDBI) was established on July 1, 1964 as a wholly-owned subsidiary of the RBI. The ownership of IDBI was then transferred to the Central Government with effect from February 16, 1976. The IDBI is the apex institution in the area of development banking and as such it has to coordinate the activities of all the other financial institutions. At the State level, the State Industrial Development Corporations (SIDCO)/State Industrial Investment Corporations were created to meet the financial requirements of the States and to promote regional development.

In 1971, the IDBI and LIC jointly set-up the Industrial Reconstruction Corporation of India (IRCI) with the main objective of reconstructing and rehabilitating sick industrial undertakings. The IRCI was converted into a statutory corporation in March 1985 and renamed as the Industrial Reconstruction Bank of India (IRBI). In 1997, the IRBI has to be completely restructured since it itself has become sick due to financing of sick industries. Now, it is converted into a limited company with a new name of Industrial Investment Bank of India (IIBI). Its objective is to finance only for expansion, diversification, modernisation, etc., of industries and thus it has become a development bank.

The Small Industries Development Bank of India (SIDBI) was set-up as a wholly-owned subsidiary of IDBI. It commenced operations on April 2, 1990. The SIDBI has taken over the responsibility of administrating the Small Industries Development Fund and the National Equity Fund.

Institution for Financing Agriculture

In 1963, the RBI set-up the Agricultural Refinance and Development Corporation (ARDC) to provide refinance support to banks to finance major development projects such as minor irrigation, farm mechanisation, land development, horticulture, daily development, etc. However, in July 1982, the National Bank for Agriculture and Rural Development (NABARD) was established and the ARDC was merged with it. The whole sphere of agricultural finance has been handed over to NABARD. The functions of the Agricultural Credit Department and Rural Planning and Credit Cell of the RBI have been taken over by NABARD.

Institution for Foreign Trade

The Export and Import Bank of India (EXIM Bank) was set-up on January 1, 1982 to takeover the operations of International Finance wing of the IDBI. Its main objective is to provide financial assistance to exporters and importers. It functions as the principal financial institution for coordinating the working of other institutions engaged in financing of foreign trade. It also provides refinance facilities to other financial institutions against their export-import financing activities.

Institution for Housing Finance

The National Housing Bank (NHB) has been set-up on July 9, 1988 as an apex institution to mobilise resources for the housing sector and to promote housing finance institutions both at regional

and local levels. It also provides refinance facilities to housing finance institutions and scheduled banks. It also provides guarantee and underwriting facilities to housing finance institutions. Again, it co-ordinates the working of all agencies connected with housing.

Stock Holding Corporation of India Ltd. (SHCIL)

Recently in 1987 another institution, *viz.,* Stock Holding Corporation of India Ltd., was set-up to tone up the stock and capital markets in India. Its main objective is to provide quick share transfer facilities, clearing services, depository services, support services, management information services and development services to investors both individuals and corporates. The SHCIL was set-up by seven All India financial institutions, *viz.,* IDBI, IFCI, ICICI, LIC, GIC, UTI and IRBI.

Mutual Funds Industry

Mutual funds refer to the funds raised by financial service companies by pooling the savings of the public and investing them in a diversified portfolio. They provide investment avenues for small investors who cannot participate in the equities of big companies. Mutual funds have been floated by some public sector banks, LIC, GIC and recently by private sector also.

Venture Capital Institutions

Venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. Much thrust is given to new ideas or technological innovations. Indeed it is a long-term risk capital to finance high technology projects. The IDBI venture capital fund was set-up in 1986. The IFCI has started a subsidiary to finance venture capital viz., The Risk Capital and Technology Finance Corporation (RCTC). Likewise the ICICI and the UTI have jointly set-up the Technology Development and Information Company of India Limited (TDICI) in 1988 to provide venture capital. Similarly many State Financial Corporations and commercial banks have started subsidiaries to provide venture capital. The Indus Venture Capital Fund and the Credit Capital Venture Fund Limited come under the private sector.

Credit Rating Agencies

Of late, many credit rating agencies have been established to help investors to make a decision of their investment in various instruments and to protect them from risky ventures. At the same time it has the effect of improving the competitiveness of the companies so that one can excel the other. Credit rating is now mandatory for all debt instruments. Similarly, for accepting deposits, non-banking companies have to compulsorily go for credit rating. Some of the credit rating agencies established are:

(i) Credit Rating and Information Services of India Ltd., (CRISIL).

(ii) Investment Information and Credit Rating Agency of India Ltd., (ICRA).

(iii) Credit Analysis and Research Ltd., (CARE).

The rating is confined to fixed deposits, debentures, preference shares and short-term instruments like commercial paper. The rating of equity shares will come into effect soon. The establishment of various credit rating agencies will go a long way in stabilising the financial system in India by supplying vital credit information about corporate customers.

Multiplicity of Financial Instruments

The expansion in size and number of financial institutions has consequently led to a considerable increase in the financial instruments also. New instruments have been introduced in the form of innovative schemes of LIC, UTI, Banks, Post Office Savings Bank Accounts, Shares and debentures of different varieties, Public Sector Bonds, National Savings Scheme, National Savings Certificates, Provident Funds, Relief Bonds, Indira Vikas Patra, etc. Thus, different types of instruments are available in the financial system so as to meet the diversified requirements of varied investors and thereby making the system more healthy and vibrant.

Legislative Support

The Indian financial system has been well supported by suitable legislative measures taken by the government then and there for its proper growth and smooth functioning. Though there are many enactments, some of them are very important. The Indian Companies Act was passed in 1956 with a view to regulating the functioning of companies from birth to death. It mainly aims at giving more protection to investors since there is a diversity of ownership and management in companies. It was a follow-up to the Capital Issues Control Act passed in 1947. Again, in 1956, the Securities Contracts (Regulation) Act was passed to prevent undesirable transactions in securities. It mainly regulates the business of trading in the stock exchanges. This Act permitted only recognised stock exchanges to function.

To ensure the proper functioning of the economic system and to prevent concentration of economic power in the hands of a few, the Monopolies and Restrictive Trade Practices Act was passed in 1970. In 1973, the Foreign Exchange Regulations Act was enacted to regulate the foreign exchange dealings and to control Indian investments abroad and *vice versa*.

The Capital Issues Control Act was replaced by setting up of the Securities Exchange Board of India. Its main objective is to protect the interest of investors by suitably regulating the dealings in the stock market and money market so as to achieve efficient and fair trading in these markets. When the government adopted the New Economic Policy, many of these Acts were amended so as to remove many unwanted controls. Banks and financial institutions have been permitted to become members of the stock market in India. They have been permitted to float mutual funds, undertake leasing business, carry-out factoring services, etc.

Besides the above, the Indian Contract Act, The Negotiable Instruments Act, The Law of Limitation Act, The Banking Regulations Act, The Stamp Act, etc., deserve a special mention. When the financial system grows, the necessity of regulating it also grows side-by-side by means of bringing suitable legislations. These legislative measures have reorganised the Indian financing system to a greater extent and have restored confidence in the minds of the investing public as well.

However, to avoid overlap in certain key areas between SEBI and other bodies such as Company Law Board, RBI, etc., it is necessary to classify the respective jurisdictions. At present, the jurisdiction is divided between the RBI (money, market, repos, debt market) and SEBI. It would be advisable to consolidate the securities laws into one comprehensive legislation on the lines of the British Financial Services and Market Act, 2000.

Financial Sector Legislative Reforms Commission (FSLRC)

The Central Government has very recently constituted the Financial Sector Legislative Reforms Commission (FSLRC) under the chairmanship of former Justice B.N. Srikrishna to rewrite and harmonise the various financial sector legislations, rules and regulations. There are over 60 Acts and multiple rules and regulations and many of them have become archaic. Moreover, large number of amendments made in these Acts over time have increased the ambiguity and complexity of the system.

FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

The financial system plays a significant role in the process of economic development of a country. The financial system comprises of a network of commercial banks. Non-banking companies, development banks and other financial and investment institutions offer a varieties of financial products and services to suit to the varied requirements of different categories of people. Since they function in a fairly developed capital and money markets, they play a crucial role in spurring economic growth in the following ways:

(i) Mobilising Savings

The financial system mobilises the savings of the people by offering appropriate incentives and by deepening and widening the financial structure. In other words, the financial system creates varieties of forms of savings so that savings can take place according to the varying asset preferences of different classes of savers. In the absence of the financial system, all savings would remain idle in the hands of the savers and they would not have flown into productive ventures.

(ii) Promoting Investments

For the economic growth of any nation, investment is absolutely essential. This, investment has to flow from the financial system. In fact, the level of investment determines the increase in output of goods and services and incomes in the country. The financial system collects the savings and channels them into investment which contributes positively towards economic development.

(iii) Encouraging Investments in Financial Assets

The dynamic role of the financial system in the economic development is that it encourages savings to flow into financial assets (money and monetary assets) as against physical assets (land, gold and other goods and services). The investments in physical assets are speculative and would breed inflation. On the other hand investments in financial assets are non-inflationary in nature and would aid growth in the economy. The larger the proportion of the financial assets, the greater is the scope for economic growth in the long run.

(iv) Allocating Savings on the Basis of National Priorities

Above all, the financial system allocates the savings in a more efficient manner so that the scarce capital may be more efficiently utilised among the various alternative investments. In other words, it gives preference to certain sectors, from the social and economic point of view, on the basis of national priorities.

(v) Creating Credit

Large financial resources are needed for the economic development of a nation. These resources are supplied by the financial system not only in the form of liquid cash but also in the form of 'created money' or 'deposit money' by creating credit and thereby making available large resources to finance trade, production, distribution, etc. Thus, it accelerates economic growth by facilitating the transactions of trade, production and distribution on a large-scale.

(vi) Providing a Spectrum of Financial Assets

The financial system provides a spectrum of financial assets so as to meet the varied requirements and preferences of household. Thus, it enables them to choose their asset portfolios in such a way as to achieve a preferred mix of return, liquidity and risk. Thus, it contributes to the economic development of a country.

(vii) Financing Trade, Industry and Agriculture

All the financial institutions operating in a financial system take all efforts to ensure that no worthwhile project – be it in trade or agriculture or industry – suffers due to lack of funds. Thus, they promote industrial and agricultural development which have a greater say on the economic development of a country.

(viii) Encouraging Entrepreneurial Talents

The financial institutions encourage the managerial and entrepreneurial talents in the economy by promoting the spirit of enterprise and risk taking capacity. They also furnish the necessary technical consultancy services to the entrepreneurs so that they may succeed in their innovative ventures.

(ix) Providing Financial Services

Sophistication and innovations have started appearing in the arena of financial intermediations as well. The financial institutions play a very dynamic role in the economic development of a country not only as a provider of finance, but also as a departmental store of finance by offering varieties of innovative financial products and services to meet the ever increasing demands of their clients both corporates and individuals.

(x) Developing Backward Areas

The integral policy of the national development plans of every country concentrates on the development of relatively less developed areas called backward areas. The financial institutions provide a package of services, infrastructure and incentives conducive to a healthy growth of industries in such backward areas and thus they contribute for the uniform development of all regions in a country.

WEAKNESSES OF INDIAN FINANCIAL SYSTEM

After the introduction of planning, rapid industrialisation has taken place. It has in turn led to the growth of the corporate sector and the government sector. In order to meet the growing requirements of the government and the industries, many innovative financial instruments have been introduced. Besides, there has been a mushroom growth of financial intermediaries to meet the ever growing financial requirements of different types of customers. Hence, the Indian financial system is more developed and integrated today than what it was 50 years ago. Yet, it suffers from some weaknesses as listed below:

(i) Lack of Coordination between Different Financial Institutions

There are a large number of financial intermediaries. Most of the vital financial institutions are owned by the government. At the same time, the government is also the controlling authority of these institutions. In these circumstances, the problem of coordination arises. As there is multiplicity of institutions in the Indian financial system, there is lack of coordination in the working of these institutions.

(ii) Monopolistic Market Structures

In India some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance, the entire life insurance business is in the hands of LIC. The UTI has more or less monopolised the mutual fund industry. The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement or lack of effort in mobilising savings of the public and so on. Ultimately it would retard the development of the financial system of the country itself.

(iii) Dominance of Development Banks in Industrial Financing

The development banks constitute the backbone of the Indian financial system occupying an important place in the capital market. The industrial financing today in India is largely through the financial institutions created by the government both at the national and regional levels. These development banks act as distributive agencies only, since, they derive most of their funds from their sponsors. As such, they fail to mobilise the savings of the public. This would be a serious bottleneck which stands in the way of the growth of an efficient financial system in the country. For industries abroad, institutional finance has been a result of institutionalisation of personal savings through media like banks, LIC, pension and provident funds, unit trusts and so on. But they play a less significant role in Indian financial system, as far as industrial financing is concerned. However, in recent times attempts are being made to raise funds from the public through the issue of bonds, units, debentures and so on. It will go a long way in forging a link between the normal channels of savings and the distributing mechanism.

(iv) Inactive and Erratic Capital Market

The important function of any capital market is to promote economic development through mobilisation of savings and their distribution to productive ventures. As far as industrial finance in India is concerned, corporate customers are able to raise their financial resources through development banks. So, they need not go to the capital market. Moreover, they don't resort to capital market since it is very erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets. The weakness of the capital market is a serious problem in our financial system.

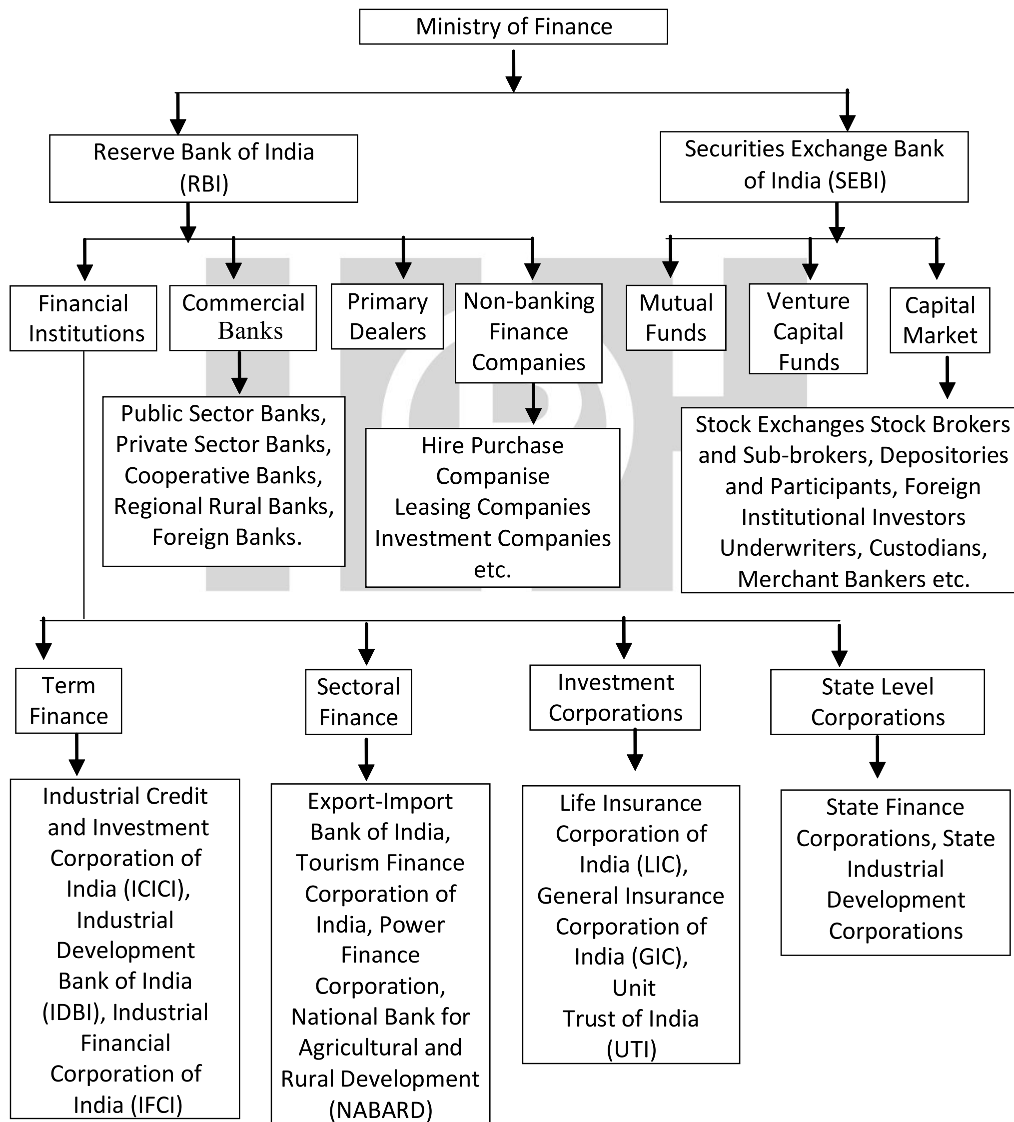
(v) Imprudent Financial Practice

The dominance of development banks has developed imprudent financial practice among corporate customers. The development banks provide most of the funds in the form of term loans. So, there is a preponderance of debt in the financial structure of corporate enterprises. This predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided. To make matters worse, when corporate enterprises face any financial crisis, these financial institutions permit a greater use of debt than is warranted. It is against the traditional concept of a sound capital structure.

However, in recent times all efforts have been taken to activate the capital market. Integration is also taking place between different financial institutions. For instance, the Unit Linked Insurance Schemes of the UTI are being offered to the public in collaboration with the LIC. Similarly, the refinance and rediscounting facilities provided by the IDBI aim at integration. Thus, the Indian financial system has become a developed one.

The structure of the Indian Financial System is displayed in the following Chart 1.4

CHART 1.4
THE STRUCTURE OF INDIAN FINANCIAL SYSTEM



Source: The Indian Banker.

QUESTIONS

Objective Types

I. Fill up the blanks with suitable word/words.

1. ___________ assets are mostly useful for consumption.
2. The market for new issues is called ___________ market.
3. Loan against the security of immovable property is called ___________ loan.
4. ___________ guarantee covers the payment of earnest money, retention money and advance payments.
5. The SHCIL was set-up in the year ___________.

*[**Ans.:** 1. Physical, 2. Primary, 3. Mortgage, 4. Performance, 5. 1987.]*

II. Choose the best answer from the following.

1. The following one is a financial asset:

   (a) gold (b) silver
   (c) share (d) land.
2. Which one of the following is a cash asset?

   (a) deposit created out of loans (b) share
   (c) bond (d) post office certificate.
3. The component of a capital market is:

   (a) Treasury Bill Market (b) Government Securities Market
   (c) Commercial Bill Market (d) a and b together.
4. The money market instrument is:

   (a) bond (b) debenture
   (c) stock certificate (d) certificate of deposit.
5. Government Bond is a:

   (a) short-term security (b) long-term security
   (c) medium-term security (d) either short-term or long-term security.

*[**Ans.:** 1. (c), 2. (a), 3. (b), 4. (d), 5. (b).]*

III. State whether the following statements are TRUE or FALSE.

1. Building bought for hiring is a financial asset.
2. LIC is primarily a money market intermediary.
3. Companies can raise capital in a primary market only through Right issues.
4. The most liquid financial market is the call money market.
5. A promissory note issued by the government is called Treasury Bill.

   *[**Ans.:** 1. True, 2. False, 3. False, 4. True, 5. True.]*

IV. Short answer type.

1. Distinguish between a physical asset and a financial asset.
2. Classify financial assets giving examples.
3. What is a money market?
4. What is a capital market?
5. Distinguish between a primary market and a secondary market.
6. What is performance guarantee?
7. State the functions of a foreign exchange market.
8. What do you mean by indirect securities? Give an example.
9. What is venture capital financing?

V. Answer the following in a paragraph.

1. What is a capital market? What are its major constituents?
2. Write a brief note on the financial guarantees market operating in India.
3. What are financial instruments? What are their characteristic features?
4. What legislative measures have been taken by the government to support the Indian financial system?
5. Classify financial assets and bring out their features.
6. State and explain the functions of the financial system in a country.

VI. Essay type questions.

1. Classify the various financial intermediaries functioning in the Indian financial system and bring out their features.
2. Show the classification of Indian financial markets in the form of a chart and explain the features of each market.

3. What do you mean by financial rate of return? What are the basic objectives of the interest rate policy of the government and what steps have been taken by the government in this direction.
4. Trace out the development of the financial system in India.
5. "In spite of suitable legislative measures, the Indian financial system remains weak". Comment.
6. Examine the role of a financial system in the economic development of a country.
7. Define a money market. Bring out the features of a developed money market and its importance.