Financial Markets, Institutions and Services

E. Gordon
K. Natarajan

Himalaya Publishing House
ISO 9001:2008 CERTIFIED
FINANCIAL MARKETS, INSTITUTIONS AND SERVICES

Prof. E. Gordon  
M.Com., M.Phil.  
Former Professor and Head,  
Dept. of Commerce,  
A.N.J.A. College, Sivakasi.

Dr. K. Natarajan  
M.Com., M.Phil., Ph.D.  
Former Principal,  
S.V.N. College, Madurai.  
&  
Former Director, Management Studies,  
Sri Kaliswari College, Sivakasi.
Consequent upon the restructuring of commerce and management curricula by many Universities, many new subjects on thrust areas have been recently introduced. One such thrust area is the ‘Financial Sector’ which comprises of Financial Markets, Financial Institutions and Financial Services.

The Indian financial system has been increasingly influenced in recent times by financial innovations in terms of products and instruments, adoption of modern technologies, opening up of the financial markets to the global economy, streamlining of the regulatory framework and so on. In the aftermath of this changing financial scenario, students of humanities are badly in need of a suitable book covering all these aspects and incorporating the latest developments in the respective fields.

Realising the imperative need to bring out a suitable book on “Financial Markets, Institutions and Services” tailored to meet the specific requirements of students of Orissa, Ravenshaw and nearby Universities, a modest attempt has been made to present this edition in the hands of the academic community. The speciality of this volume is that all the matters are presented in a lucid manner and in simple language. All latest developments have been covered and above all, it is most student-friendly. This book owes its consummation to various distinguished personalities who have expressed their views on this subject in different books, journals, magazines and papers.

We are greatly indebted to all our wellwishers for their constant inspiration and motivation, without which it would have been impossible to bring out this edition. We place on record our profound thanks to the Himalaya Publishing House Pvt. Ltd., particularly Mrs. Meena Pandey, Shri Niraj Pandey, Shri K.N. Pandey, Shri Anuj Pandey and Mrs. Nimisha Kadam and other members of the publishing house for bringing out this edition in time and in an elegant manner.

Critical comments and constructive suggestions for the improvement of this book are most welcome and will be greatly appreciated.

Sivakasi
November, 2017

E. Gordon
K. Natarajan
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Financial System</td>
<td>1 – 22</td>
</tr>
<tr>
<td>2</td>
<td>Money Market</td>
<td>23 – 60</td>
</tr>
<tr>
<td>3</td>
<td>Primary Market/New Issue Market</td>
<td>61 – 90</td>
</tr>
<tr>
<td>4</td>
<td>Secondary Market/Stock Exchange</td>
<td>91 – 144</td>
</tr>
<tr>
<td>5</td>
<td>Financial Institutions — Commercial Banks</td>
<td>145 – 164</td>
</tr>
<tr>
<td>6</td>
<td>Development Financial Institutions</td>
<td>165 – 183</td>
</tr>
<tr>
<td>7</td>
<td>Non-Banking Financial Institutions</td>
<td>184 – 197</td>
</tr>
<tr>
<td>8</td>
<td>Mutual Funds</td>
<td>198 – 220</td>
</tr>
<tr>
<td>9</td>
<td>Merchant Banking</td>
<td>221 – 238</td>
</tr>
<tr>
<td>10</td>
<td>Leasing</td>
<td>239 – 257</td>
</tr>
<tr>
<td>11</td>
<td>Hire Purchase</td>
<td>258 – 265</td>
</tr>
<tr>
<td>12</td>
<td>Factoring</td>
<td>266 – 287</td>
</tr>
<tr>
<td>13</td>
<td>Venture Capital</td>
<td>288 – 306</td>
</tr>
<tr>
<td>14</td>
<td>Credit Rating</td>
<td>307 – 322</td>
</tr>
</tbody>
</table>
OBJECTIVES:

The main objectives of this chapter are to enable the students:

- To understand the meaning and significance of the financial system
- To analyse the various functions of the financial system
- To classify financial assets and discuss their features
- To discuss the various classification of financial markets and their features
- To have an exposure to the features and classification of financial instruments
- To evaluate the Indian financial system and assess its weaknesses

STRUCTURE:

1.1 Meaning and Significance
1.2 Functions of the Financial System
1.3 Financial Concepts
1.4 Financial Assets
1.5 Financial Intermediaries
1.6 Financial Markets
1.7 Importance of Capital Market
1.8 Money Market
1.1 MEANING AND SIGNIFICANCE

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.

1.2 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 of value and time. 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 savings 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 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.

1.3 FINANCIAL CONCEPTS

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

(i) Financial assets.
(ii) Financial intermediaries.
(iii) Financial markets.
(iv) Financial rates of return.
(v) Financial instruments.

1.4 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 residence 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](chart)

**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.

1.5 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 as shown in Chart 1.2. 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, co-operative banks, etc.

**1.6 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.

(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, 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 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.
STRIPS – Separate Trading of Registered Interest and Principal of Securities

With a view to improving liquidity and widening the investor base of the Government Securities market, stripping and reconstitution of Government Securities have been permitted under the Government Securities Act, 2006. Stripping is nothing but the process of separating a standard coupon leaving bond into its constituent interest and principal components. For example, stripping a 15-year security would yield 30 coupon securities (generally coupon payments are made on Jan 2 and July 2) maturing on the respective coupon dates and one principal security representing the principal amount maturing on the redemption date of the 15-year security. All the 30 coupon securities and the principal security would thereafter become zero coupon bonds. The reverse of stripping in called reconstitution. That is, when all the coupon STRIPS and the principal STRIPS are reassembled into the original Government Security, it is called reconstitution.

The special feature of STRIPS is that the coupon STRIPS of the same date, though from different stocks are exchangeable since they are identical by their maturity dates. STRIPS provide additional instruments to institutional investors for their asset-liability management. Again, STRIPS have zero investment risk (discounted instruments with no periodic interest payment). Stripping/Reconstitution can be done at the option of the holder at any time from the date of issues of a Government Security till its maturity. The minimum amount of securities that needs to the submitted for Stripping/Reconstitution will be ₹ 1 crore (face value) and multiples thereof.

R. Gandhi Committee’s Recommendations

To enhance liquidity in the Government Securities market and Interest Rate Derivatives market, the following measures have been taken on the recommendations of the above Committee:

(i) The auction bid timing has been reduced from 120 minutes to 90 minutes.
(ii) The settlement cycle of the primary auction for T-Bills has been changed from T 2 to T 1 basis.
(iii) Buyback/switching of Government securities has been introduced for ₹ 500 billion.
(iv) The investment limit for FIIs will be gradually raised to US $ 30 billion.
(v) Inflation-indexed bonds have been launched.

(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:

(i) Term loans market.
(ii) Mortgages market.
(iii) Financial guarantees market.

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 IRBI, IFCI, 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.

**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.

**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.

1.7 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 the 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 sector 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 their savings.

1.8 MONEY MARKET

Money market is a market for dealing with financial assets and securities which have a maturity period of up to one year. In other words, it is a market for purely short-term funds. 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.
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 Mumbai, Kolkata, 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.

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 the amount 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.

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.

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.
1.9 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 (FEMA).

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.

Brokers play a significant role in the foreign exchange market in India. Apart from authorised dealers, the RBI has permitted licensed hotels and individuals (known as Authorised Money Changers) to deal in foreign exchange business. The FEMA helps to smoothen the flow of foreign currency and to prevent any misuse of foreign exchange which is a scarce commodity.

Financial rates of returns

Most households in India still prefer to invest on physical assets like land, buildings, gold, silver, etc. But, studies have shown that investment in financial assets like equities in capital market fetches more return than investments on gold. It is imperative that one should have some basic knowledge about the rate of return on financial assets also.

The return on Government Securities and bonds are comparatively less than on corporate securities due to lower risk involved therein. The Government and the RBI determine the interest rates on Government Securities. Thus, the interest rates are administered and controlled. The peculiar feature of the interest rate structure is that the interest rates do not reflect the free market forces. They do not reflect the scarcity value of capital in the country also. Most of these rates are fixed on an ad hoc basis depending upon the credit and monetary policy of the Government.

Generally, the interest rate policy of the Government is designed to achieve the following:

(i) To enable the Government to borrow comparatively at cheaper rate.

(ii) To ensure stability in the macroeconomic system.
(iii) To support certain sectors through preferential lending rates.
(iv) To mobilise substantial savings in the economy.

The interest rate structure for bank deposits and bank credits is also influenced by the RBI. Normally, interest is a reward for risk undertaken through investment and at the same time it is a return for abstaining from consumption. The interest rate structure should allocate scarce capital between alternative uses. Unfortunately, in India the administered interest rate policy of the Government fails to perform the role of allocating scarce resources between alternative uses.

**Recent trends**

With a view to bring the interest rates nearer to the free market rates, the Government has taken the following steps:

(i) The interest rates on company deposits are freed.
(ii) The interest rates on 364 days Treasury Bills are determined by auctions and they are expected to reflect the free market rates.
(iii) The coupon rates on Government loans have been revised upwards so as to be market-oriented.
(iv) The interest rates on debentures are allowed to be fixed by companies depending upon the market rates.
(v) The maximum rates of interest payable on bank deposits (fixed) are freed for all deposits.

Thus, all attempts are being taken to adopt a realistic interest rate policy so as to give a positive return in real terms adjusted for inflation. The proper functioning of any financial system requires a good interest rate structure.

### 1.10 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 to five years, e.g., Debentures maturing within a period of five years. Long-term securities are those which have a maturity period of more than five years, e.g., Government Bonds maturing after ten years.

Characteristic 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.
Financial Markets Regulation Department (FMRO)

The FMRD was set up on November 3, 2014 with a view to regulating, developing and overseeing the financial markets operating in India in an integrated manner. It also aims at strengthening the financial market infrastructure and market surveillance in line with global standards. For this purpose, it has to find out ways and means to make market access norms easier for all participants in addition to expanding the menu of financial products and services across all segments of financial markets including derivatives markets. Further, it has to leverage the market analytics and surveillance mechanism for appropriate policy inputs. It is expected that this department will take necessary measures to make the financial markets more efficient and transparent.

1.11 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 investment 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, investment 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 households. 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.

1.12 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, a major share of 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 Indian Financial System is displayed in the following Chart 1.4.
1.13 SUMMARY

- Financial system mobilises savings in the form of money and monetary assets and invests in productive ventures. It includes financial markets and financial institutions that support the system.
- The major functions of financial system are provision of money and monetary assets for production of goods and services, transformation of savings into investment, transformation of savings of millions of small investors into perceptible size of credit unit, accepting deposits of different maturities and lending to borrowers of different maturities and distribution of risk of individual investors.
- A financial asset is one which is used for production or consumption or for further creation of assets. Financial assets are classified as marketable assets which can be transferred easily and non-marketable assets which cannot be transferred easily.
- Financial markets are centres and arrangements which facilitate buying and selling of financial assets. Financial markets are classified as unorganised markets which include money lenders, indigenous
bankers etc. and unorganised markets which include capital market and money market. Capital market is divided into: (i) industrial securities market, (ii) Government securities market and (iii) long term loans market. Money market is subdivided as call money market, commercial bills market, treasury bills market and short term loan market.

- Financial instruments refer to those documents which represent financial claims on assets. Financial instruments are classified as: (i) primary securities and (ii) secondary securities.
- Some of the weaknesses of Indian financial systems are lack of co-ordination between financial institutions, monopolistic structure, dominance of development banks, inactive and erratic capital market and imprudent financial practices among corporate customers.

1.14 QUESTIONS

OBJECTIVE TYPE QUESTIONS

I. FILL IN THE BLANKS

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 cover the payment of earnest money, retention money and advance payments.
5. The SHCIL was set up in the year ______.


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 Rights Issue.
4. The most liquid financial market is the call money market.
5. A promissory note issued by the Government is called Treasury Bill.


IV. MATCH THE FOLLOWING

1. Marketable assets
2. Call money market
3. Government Bond
4. Commercial Bill Market
5. Guilt-edged securities market

(a) Government securities
(b) Genuine trade transactions
(c) Long term security
(d) Short period loan
(e) Shares

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

V. SHORT ANSWER TYPE QUESTIONS

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?
10. What is STRIPS?

VI. PARAGRAPH TYPE QUESTIONS

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. Distinguish between stripping and reconstitution.
VII. 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. Discuss the role of the financial system in the economic development of a country.