Unit -1 FINANCIAL MARKETS IN INDIA

Financial_System

Objectives

After studying this unit, you will be able to:

- Explain the functions of financial system
- Describe the components of financial system

Introduction

The questions and challenges that the world faces in the current times are fundamentally different from those that it has wrestled with for decades after decades. Liberalization and globalization have breathed new life into the foreign exchange markets while simultaneously besetting them with new challenges. Commodity trading, particularly trade in commodity futures, have practically started from scratch to attain scale and attention. The banking industry has moved from an era of rigid controls and government interference to a more market-governed system. New private banks have made their presence felt in a very strong way and several foreign banks have ventured into territories other than their own. Financial market provides channels for allocation of savings of assets to savers as well as various forms in which the investors can raise funds.

1.1 Functions of Financial System

The functions of a good financial system are manifold. They are as follows:

1. ***Regulation of currency:*** As a part of the financial system, central banks generally control the supply of a currency and interest rates, while currency traders control exchange rates.

2. Banking functions

to assemble capital and make it effective;

- to receive deposits and make collections;
- to check out and transfer funds;

✓ **Performance of agency services and custody of cash reserves:** Different constituents of the financial system act as the agents for their clients. They buy and sell shares and bonds, receive and pay utility bills, premiums, dividends, rents and interest for their clients.

✓ **Management of national reserves of international currency:** Various parts of financial system help the economy in particular and polity in general to manage international reserve.

✓ **Credit control:** Financial system controls credit by serving the dual purpose of:

- increasing sales revenue by extending credit to customers who are deemed a good credit risk, and
- minimizing risk of loss from bad debts by restricting or denying credit to customers who are not a good credit risk.

✓ **Ensure stability of the economy:** Financial system performs the function of administering national, fiscal, and monetary policy to ensure the stability of the economy.

- ✓ **Supply and deployment of funds for productive use:** Financial markets permit the transfer of funds (purchasing power) from one agent to another for either investment or consumption purposes.
- ✓ **Maintaining liquidity:** Financial markets provide the holders of financial assets with a chance to resell or liquidate these assets.
- ✓ **Price determination:** Financial markets provide vehicles by which prices are set both for newly issued financial assets and for the existing stock of financial assets.
- ✓ **Information aggregation and coordination:** Financial markets act as collectors and aggregators of information about financial asset values and the flow of funds from lenders to borrowers.
- ✓ **Risk sharing:** Financial markets allow a transfer of risk from those who undertake investments to those who provide funds for those investments.
- ✓ **Improve efficiency:** Financial markets reduce transaction costs and information costs.
- ✓ **Ensure long term growth to itself:** Long-term growth of financial markets is ensured through:
    - Giving autonomy to Financial Institutions to become efficient under competition
    - Education of investors
    - Consolidation through mergers
    - Facilitating entry of new institutions to add depth the market

- Minimizing regulatory measures and market segmentation.

Structure of Financial Market In India

Outlook for Indian Financial Markets: Stocks up,Rates Down?

markets is still only "increasing" and there is yet some policy restriction with respect to seamless flow of capital between the local and international markets, there have been differing reactions in various segments of the financial markets in India.

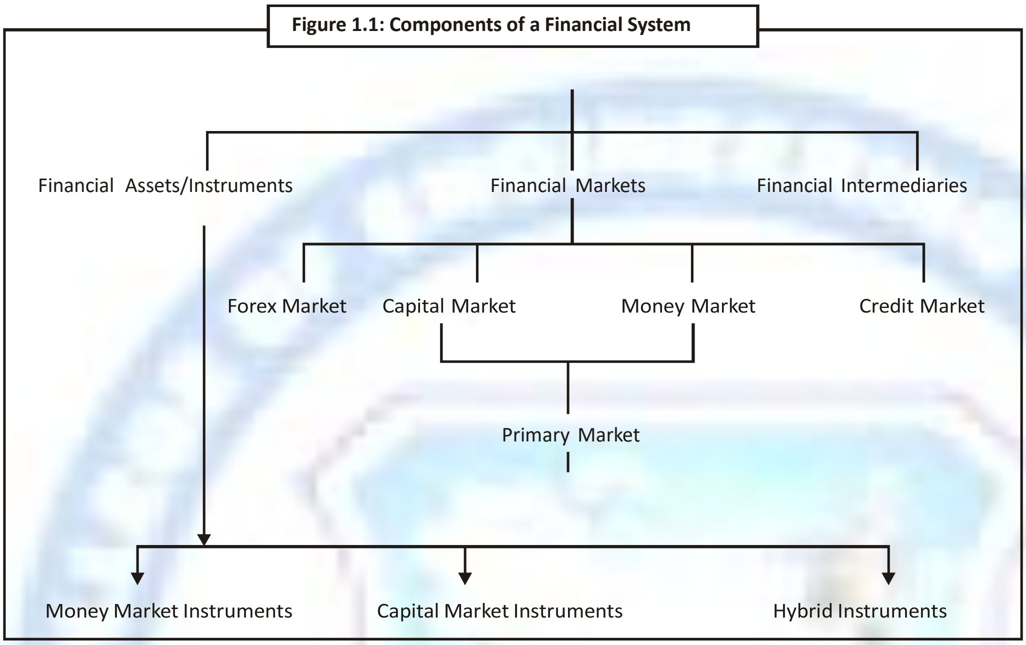
Equities have fallen quite sharply as the international exposure of the domestic stock markets is relatively much higher than that of the other key financial market segment, namely, debt.

The debt markets, dominated by government debt and with very limited international participation, have been influenced only by prevailing liquidity conditions (and perceptions about the same) in the domestic banking system.

Sovereign bond yields have moved up in the past couple of weeks, particularly in the last couple of days, as the Reserve Bank of India put in place some measures for broadly stabilising/restricting the liquidity level in the financial system.

Therefore, while equity markets have moved in sympathy with stocks globally, the Indian bond market has seen yields rising while globally sovereign bond yields have fallen substantially.

1.2 Components of Financial System



The financial system consists of the Central Bank, as the apex financial institution, other regulatory authorities, financial institutions, markets, instruments, a payment and settlement system, a legal framework and regulations. The financial system carries out the vital financial intermediation function of borrowing from surplus units and lending to deficit units. The legal framework and regulators are needed to monitor and regulate the financial system. The payment and settlement system is the mechanism through which transactions in the financial system are cleared and settled.

1. Regulatory Authorities
2. Financial Institutions
3. Financial Markets
4. Financial Instruments
5. Payment and Settlement Infrastructure. Let us get

introduced to them one by one.

Regulatory Authorities

The main component of any financial system is the regulatory system it has. In any economy, the financial system is regulated by the central banking authority of that country. In India, the central banking bank is named as the Reserve Bank of India.

Reserve Bank of India (RBI)

The regulation and supervision of banking institutions is mainly governed by the Companies Act, 1956, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, Bankers' Books Evidence Act, Banking Secrecy Act and Negotiable Instruments Act, 1881.

The regulation and supervision of finance companies is done by the Banking Regulation Act, 1949 which governs the financial sector.

Individual Institutions are regulated by Acts like:

1. State Bank of India Act, 1954
2. The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003
3. The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993
4. National Bank for Agriculture and Rural Development Act

5. National Housing Bank Act
6. Deposit Insurance and Credit Guarantee Corporation Act.

Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India was made a statutory body on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992 to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto.

Insurance Regulatory and Development Authority (IRDA)

Insurance Regulatory and Development Authority regulates and supervises the insurance industry-insurance companies and their agents and insurance brokers to protect the interests of the policyholders, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto.

Financial Institutions

The financial system consists of many financial institutions. While most of them are regulated by the Reserve Bank, there are some which it manages just indirectly.

Institutions regulated by the Reserve Bank of India

The institutions regulated by the RBI are:

1. Nationalised Commercial Banks
2. Specialised Banks
3. Registered Finance Companies
4. Registered Finance Leasing Establishments
5. Micro-finance Institutions.

Institutions not regulated by the Reserve Bank of India

Certain financial institutions are not regulated by the Reserve Bank of India. These include securities firms, investment banks and mutual funds which come under the purview of the SEBI, Insurance Companies and Insurance Brokers which are regulated by the IRDA, etc.

Financial Markets

The Financial Market, which is the market for credit and capital, can be divided into the Money Market and the Capital Market. The Money Market is the market for short-term interest-bearing assets.

Examples:

1. Treasury bills
2. Commercial paper
3. Certificates of deposits

The major task of the Money Market is to facilitate the liquidity management in the economy. The Capital Market is the market for trading in medium-long-term assets.

Examples: 1. Treasury bonds

2. Private debt securities (bonds and debentures)
3. Equities (shares)

The main purpose of the Capital Market is to facilitate the raising of long-term funds.

Did u know? The main issuers in the

1. ***Money Market*** are the Government, banks and private companies, while the main investors are banks, insurance companies and pension and provident funds.
2. ***Capital Market*** are the Government, banks and private companies, while the main investors are pension and provident funds and insurance companies.

The Financial Market can also be classified according to instruments, such as the debt market and the equity market. The debt market is also known as the Fixed Income Securities Market and its segments are the Government Securities Market (Treasury bills and bonds) and the Private Debt Securities Market (commercial paper, private bonds and debentures). Another distinction can also be drawn between primary and secondary markets. The

Primary Market is the market for new issues of shares and debt securities, while the Secondary Market is the market in which existing securities are traded.

The Reserve Bank of India through its conduct of monetary policy influences the different segments of the Financial Market in varying degrees. The Reserve Bank's policy interest rates have the greatest impact on a segment of the Money Market called the inter-bank call money market and a segment of the Fixed Income Securities Market, i.e. the Government Securities Market.

Financial Instruments

The main financial instruments can be categorized as under:

Deposits

Deposits are sums of money placed with a financial institution, for credit to a customer's account. There are three types of deposits — demand deposits, savings deposits and fixed or time deposits.

Demand deposits are mainly used for transaction purposes and for the safekeeping of funds. Funds can be withdrawn on demand. Demand deposits do not earn interest, but banks provide a number of services to demand deposit-holders like cheque facilities, standing orders, Automated Teller Machine (ATM) cards and debit cards to facilitate withdrawals and payments.

Savings deposits earn interest, which may be calculated on a daily, weekly, monthly or annual basis. Funds may be withdrawn from savings accounts at any time. However, if the number of withdrawals exceeds four in any month, interest will not be paid for that particular month. Financial institutions issue passbooks or statements detailing transactions to savings deposit holders and also provide services such as ATM and debit cards.

Fixed or time deposits are funds placed at financial institutions for a specified period or term. Fixed/time deposits earn a higher rate of interest than savings deposits. Fixed/time deposits can be for short, medium or long term. Funds can only be withdrawn before the maturity date with prior notice and a penalty may be imposed. A fixed/time deposit holder has a facility to borrow funds from the financial institution using the deposit as collateral.

Loans

A loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in installments or all at once, on agreed dates and at an agreed rate of interest. In most cases, financial institutions require some form of security for loans.

Treasury Bills and Bonds

Treasury bills are government securities that have a maturity period of up to one year. Treasury bills are issued by the central monetary authority (the RBI), on behalf of the Government of India. Treasury bills are issued in maturities of 91 days, 182 days and 364 days. Treasury bills are zero coupon securities and are sold at a discount to face value, which is paid at maturity. The difference between the purchase price and the face value is the interest income to the owner Treasury bills are considered liquid assets as they can be easily sold in the secondary market and converted to cash. Treasury bonds are medium and long-term government securities and are issued in maturities ranging from 2 years to 20 years. Treasury bills and bonds are guaranteed by the Government and are the safest of all investments, as they are default risk free. Treasury bills and bonds are tradable securities which are sold by auction to Primary Dealers, who in turn market the securities to the public.

The yields on Treasury bills and bonds are market determined and the market is both active and liquid.

Repurchase Agreements

Repurchase agreements (Repo) are arrangements involving transaction between two parties that agree to sell and

Task Find out the differences between the sale price and the repurchase price from the financial system of India.

repurchase the same security. Under repurchase agreement, the seller sells the specified securities to the buyer with an agreement to repurchase the same at a mutually decided future date and price. Such kind of transaction between parties approved by RBI and in securities (Treasury Bills, Central/State Govt. securities) as approved by RBI.

Commercial Paper

Commercial Papers (CPs) are short-term, non-collateralised (unsecured) debt securities issued by private sector companies to raise funds for their own use, by banks and other financial intermediaries. CPs are generally issued by creditworthy (high-rated) institutions in large denominations and have additional bank guarantees of payment. CPs are usually sold at a discount, although some are interest bearing.

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Corporate bonds are medium or long-term securities of private sector companies which obligate the issuer to pay interest and redeem the principal at maturity. Corporate bonds that are not backed by a specific asset are called debentures.

Debentures are medium or long term, interest-bearing bonds issued by private sector companies, banks and other financial institutions that are backed only by the general credit of the issuer. Debentures are usually issued by large, well-established institutions. The holders of debentures are considered creditors and are entitled to payment before shareholders in the event of the liquidation of the issuing company.

1. ***Convertible Debentures*** are debentures issued with an option to debenture holders to convert them into shares after a fixed period. A convertible debenture is a type of debenture or commercial loan that gives the choice to the lender to take stock or shares in the company, as an alternative to taking the repayment of a loan. It is any form of debenture which can be converted into some other kind of security like shares or Common Stocks.

   Convertible debentures are either partially or fully convertible. In case of partially convertible debentures, part of the instrument is redeemed and part of it is converted into