Lecture Notes

On

Introduction of Financial System and Financial Reforms

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Subject – Management of Financial Institutions

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INDIAN FINANCIAL SYSTEM

Meaning and Definition of Financial System

The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether it be the mobilization of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

According to Christy, the objective of the financial system is to "supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilization of resources without the destabilizing consequence of price level changes or unnecessary interference with individual desires".

According to Robinson, the primary function of the system is "to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth".

A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. It is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.

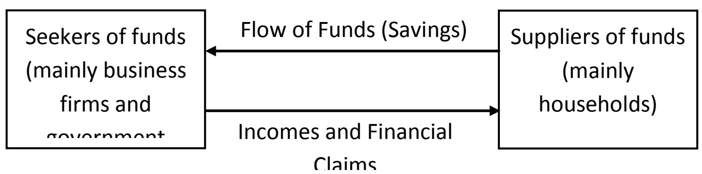

Figure 1.1: Flow of Financial Services

The word "system", in the term "financial system", implies a set of complex and closely connected or interlined institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. The financial system is concerned about money, credit and finance – the three terms are intimately related, yet are somewhat different from each other. Indian financial system consists of financial market, financial instruments and financial intermediation.

Features of Financial System

The features of a financial system are as follows:

1) Financial system provides an ideal linkage between depositors and investors, thus encouraging both savings and investments.
2) Financial system facilitates expansion of financial markets over space and time.
3) Financial system promotes efficient allocation of financial resources for socially desirable and economically productive purposes.
4) Financial system influences both the quality and the pace of economic development.

Functions of Financial System

A good financial system serves in the following ways:

1) **Link between Savers and Investors:** One of the important functions of a financial system is to link the savers and investors and thereby help in mobilizing and allocating the savings

efficiently and effectively. By acting as an efficient medium for allocation of resources, it permits continuous up gradation of technologies for promoting growth on a sustained basis.

2) **Helps in Projects Selection:** A financial system not only helps in selecting projects to be funded but also inspires the operators to monitor the performance of the investment. It provides a payment mechanism for the exchange of goods and services, and transfers economic resources through time and across geographic regions and industries.

3) **Allocation of Risk:** One of the most important functions of a financial system is to achieve optimum allocation of risk bearing. It limits, pools, and trades the risks involved in mobilizing savings and allocating credit. An efficient financial system aims at containing risk within acceptable limits and reducing the cost of gathering and analyzing information to assist operators in taking decisions carefully.

4) **Information Available:** It makes available price-related information which is a valuable assistance to those who need to take economic and financial decisions.

5) **Minimizes Situations of Asymmetric Information:** A financial system minimizes situations where the information is asymmetric and likely to affect motivations among operators or when one party has the information and the other party does not. It provides financial services such as insurance and pension and offers portfolio adjustment facilities.

6) **Reduce Cost of Transaction and Borrowing:** A financial system helps in the creation of a financial structure that lowers the cost of transactions. This has a beneficial influence on the rate of return to savers. It also reduces the cost of borrowing. Thus, the system generates an impulse among the people to save more.

7) **Promotion 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. In other words, the 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.

8) **Financial Deepening and Broadening:** A well-functioning financial system helps in promoting the process of financial deepening and broadening. **Financial deepening** refers to an increase of financial assets as a percentage of the Gross Domestic Product (GDP). **Financial broadening** refers to building an increasing number and a variety of participants and instruments.

Role of Financial System

Financial system performs play role of economic development and promotional role.

Role of Economic Development

Economic development or economic progress has been defined in two ways;

1) **Economic Growth Means Growth of National Income of the Country:** It implies an increase in the net national product in a given periods, say, a year. Some economists consider this definition as inadequate and unsatisfactory. They argue that even if the national income goes up, the general standard of living may go down. This can happen if population of the country is rising more rapidly than the growth of the national income. If the national income is rising at the rate of 2 percent and population is increasing at the rate of 3 percent, the level of living of the people is bound to go down. This is because on account of population increasing at a higher rate than the growth of the national income, per capita income falls and when per capita income goes down, we cannot call it economic growth. The country will

have registered economic growth only if per capita income has gone up and this will happen only if the national income grows at a higher rate than the growth rate of the population.

2) **Economic Growth Means the Increase in Per Capita Income of the Country at Constant Prices:** A better definition of economic development will be to base it on per capita income. Here economic growth means the increase in per capita income of the country at constant prices. A higher per capita income would mean that people are better off and enjoy a higher standard of living, and to raise the level of living of the people is the main objective of economic development, but the increase in national income or per capita income must be maintained for a long time. A temporary or short-lived increase will not connote real economic growth.

The best definition of economic development would be to say what a developed country would be like. "Economic progress is the advancement of a community along the line of evolving new and better methods of production, and rising of the levels of output through development of human skill and energy, better organization and the acquisitions of capital resources." This is, in a nutshell, what economic development means.

Promotional Role of the Financial System

The mutual interactions between the financial and real system may take promotional or developmental forms. It is in this context that the development role of the financial system is to be emphasized.

This role assumes two forms; innovation and promotion, which are inter-related.

1) **Innovation:** The innovatory role relates to the creative activity of these institutions. Thus, dynamisms as well as creative imagination can be in both the assets and liabilities side of the activities of financial institutions. This takes the form of improving the quality of assets as well as showing new and more profitable activities or keeping pace with the developmental priorities of the Government.

   This creative element in the case of commercial banks can be seen in the Lead Bank Scheme, financing of neglected sectors, opening of branches in the rural areas, etc. The creative role in the case of development banker takes the form of a critical examination of the appraisal and follow-up actions including the application of social cost benefit analysis. The development banker follows sound appraisal techniques including the economic and financial tools both from the point of view of the company as well as the economy. The industrialist finds a contractive partner in the banker who will help him in improving his project plan and prospects of investment.

2) **Promotion:** The financial institutions by virtue of long experience, expertise and information, which they acquire during the course of their project appraisal, are in a better position to play the promotional role in the economy.

   Firstly, they can share their expertise with their clients and improve the project preparation, plug up the loopholes in their schemes and advice them on improving project prospects as well as on the new areas they can explore.

   Secondly, these institutions have established their own training institutions or schools as in the case of IFC (Management Development Institute) and ICICI (Institute of Financial Management), etc.

   Thirdly, they are instrumental in setting up consultancy companies, accounting firms, leasing companies and industrial estates, etc. The I.D.B.I. with the help of other institutions has set up at State levels various consultancy service centre. Iran and Greece have also set up similar institutions.

Fourthly, development bankers can share their experience with the government in the formulation of their financial policy as their experience with projects and project implementation would help the government. Their day-to-day market knowledge about the demand pattern, export market etc., would also enable the development bankers to advise the government.

Weakness of Financial System

After the introduction of planning, rapid industrialization 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 demand of the government and Industries, many innovative financial instruments have been introduced. The Indian financial system is now more developed and integrated today than what it was few years ago. Yet it suffers from some weaknesses.

Following are the weakness of Indian financial system.

1) **Lack of Coordination between different Financial Institutions:** There are a large number of FIs. Most of the vital FIs 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.
2) **Monopolistic Market Structures:** In India, some FIs are so large that they have created a monopolistic market structure of financial system. For instance, almost entire life insurance business is in the hands of LIC of India. So large structures could delay development of financial system of the country itself.
3) **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 FI created by the government, both at the national and regional levels. As such, they fail to mobilize the savings of the public. However, in recent times attempts have been made to raise funds from public through the issue of bonds, units, debentures and so on.
4) **Inactive and Erratic Capital Market:** The Indian capital market is not strong and dependable. Because of regular scams and frauds, general public is not having faith in the Capital Markets. The weakness of the capital market is a serious problem in Indian financial system.
5) **Imprudent Financial Practices:** The dominance of development banks has developed imprudent financial practice among corporate customer. The development banks provide most of the funds in the form of term loans. So the predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided. However in recent times, all efforts have been made to activate the capital market. Integration is also taking place between different FIs. Similarly, the refinance and rediscounting facilities provided by the IDBI aim at integration.

Thus, the Indian Financial System is undergoing fast changes, to become a well developed one.

Constituents of Financial System

The financial system consists of four segments or components. These are: financial institutions, financial markets, financial instruments, and financial services.

1) **Financial Institutions:** Financial institutions are intermediaries that mobilize savings and facilitate the allocution of funds in an efficient manner.

   Financial institutions can be classified as banking and non-banking financial institutions. Banking institutions are creators of credit while non-banking financial institutions are purveyors of credit. While the liabilities of banks are part of the money supply, this may not be true of non-banking financial institutions. In India, non-banking financial institutions, namely, the Developmental Financial Institutions (DFIs) and Non-Banking Financial Companies (NBFCs) as well as housing finance companies (HFCs) are the major institutional purveyors of credit.

   Financial institutions can also be classified as term-finance institutions such as the Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Financial Corporation of India (IFCI), Small Industries Development Bank of India (SIDBI) and Industrial Investment Bank of India (IIBI).
   For Detail Refer Unit 2 and Unit 3

2) **Financial Markets:** Financial markets are a mechanism enabling participants to deal in financial claims. The markets also provide a facility in which their demands and requirements interact to set a price for such claims.

   The main organized financial markets in India are the money market and capital market. The first is a market for short-term securities while the second is a market for long term securities, that is, securities having a maturity period of one year or more.

3) **Financial Instruments:** A financial instrument is a claim against a person or an institution for the payment at a future date a sum of money and/or a periodic payment in the form of interest or dividend. The term 'and/or' implies that either of the payments will be sufficient but both of them may be promised.

   Financial securities may be primary or secondary securities:
   i) **Primary Securities:** Primary securities are also termed as direct securities as they are directly issued by the ultimate borrowers of funds to the ultimate savers. **For example**, primary or direct securities include equity shares and debentures.

   ii) **Secondary Securities:** Secondary securities are also referred to as indirect securities, as they are issued by the financial intermediaries to the ultimate savers. Mutual fund units, insurance policies and bank deposits are secondary securities.

   Financial instruments differ in terms of marketability, liquidity, reversibility, type of options, return, risk and transaction costs. Financial instruments help the financial markets and the financial intermediaries to perform the important role of channelizing funds from lenders to borrowers.

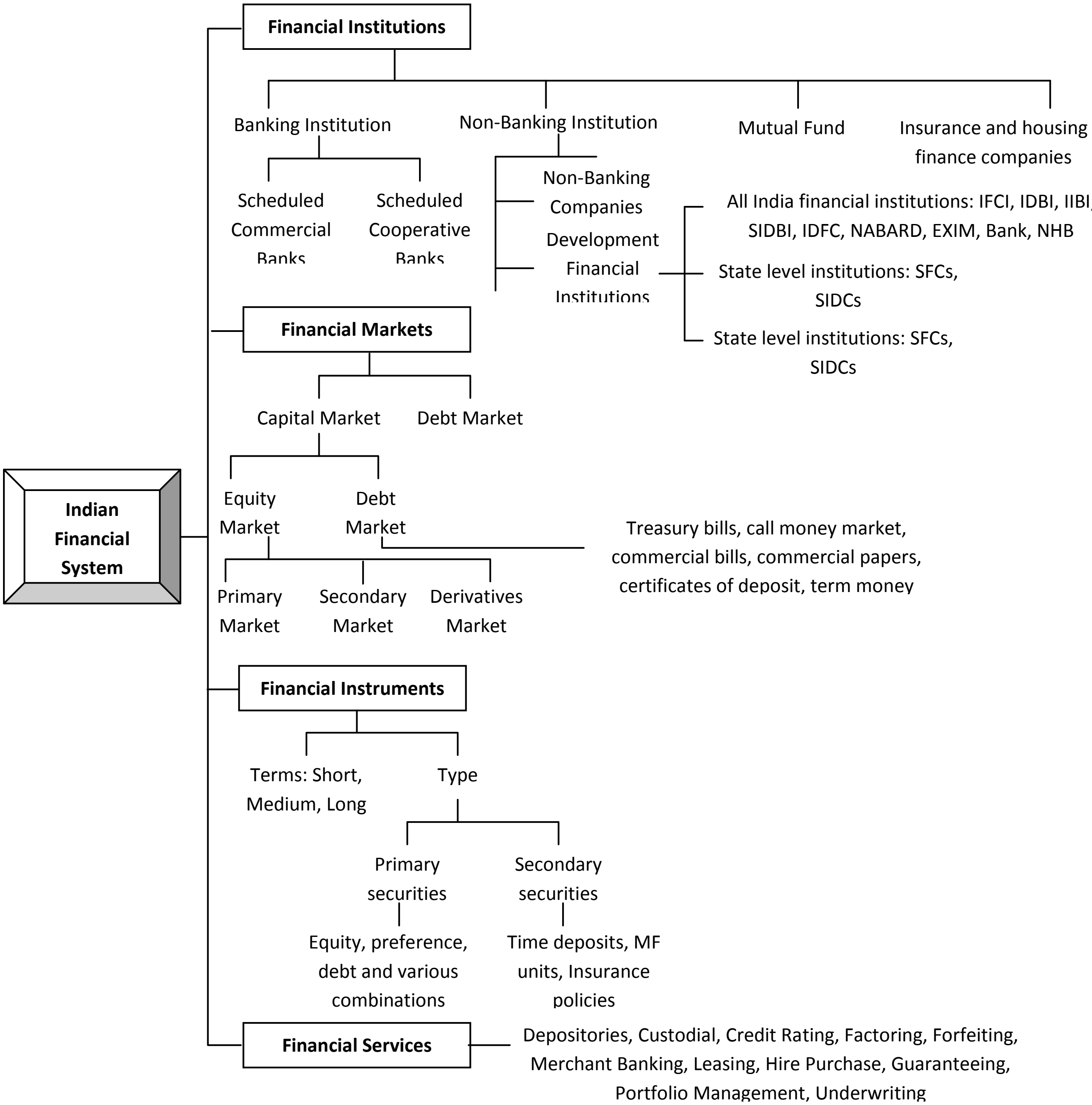

Figure 1.2

4) **Financial Services:** Financial intermediaries provide key financial services such as merchant banking, leasing, hire purchase, credit-rating, and so on. Financial services rendered by the financial intermediaries bridge the gap between lack of knowledge on the part of investors and increasing sophistication of financial instruments and markets. These financial services are vital for creation of firms, industrial expansion, and economic growth.

   Before investors lend money, they need to be reassured that it is safe to exchange securities for funds. This reassurance is provided by the financial regulator who regulates the conduct of the market, and intermediaries to protect the investors' interests. The Reserve Bank of India regulates the money market and Securities and Exchange Board of India (SEBI) regulates capital market.

FINANCIAL SECTOR REFORMS IN INDIA

The New Economic Policy (NEP) of structural adjustments and stabilization programme was given a big thrust in India in June 1991. The financial system reforms have received special attention as a part of this policy because of the perceived inter-dependent relationship between the real and financial sectors of the modern economy. Immediately after the announcement of NEP, the government had appointed a high level committee on financial system "to examine all aspects relating to the structure, organization, functions and procedures of the financial system". The committee submitted its main report in November 1991. Since then, the authorities have introduced a large number of changes or reforms in the Indian financial sector in the light of the said report.

The need for financial reforms had arisen because the financial institutions and markets were in a bad shape. The banking sector suffered from lack of competition, low capital base, low productivity, and high intermediation costs. The role of technology was minimal, and the quality of service did not receive adequate attention. Proper risk management system was not followed, and prudential norms were weak. All these resulted in poor assets quality. Development financial institutions operated in an over-protected environment with most of the funding coming from assured sources. There was little competition in insurance and mutual funds industries.

Financial markets were characterized by control over pricing of financial assets, barriers to entry, and high transactions costs. The banks were running either at a loss or on very low profits, and, consequently were unable to provide adequately for loan defaults, and build their capital.

There had been organizational inadequacies, the weakening of management and control functions, the growth of restrictive practices, the erosion of work culture, and flaws in credit management. The strain on the performance of the banks had emanated partly from the imposition of high Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), and directed credit programs for the priority sectors – all at below market or concessional or subsidized interest rates. This, apart from affecting bank profitability adversely, had resulted in the low or repressed or depressed interest rates on deposits and in higher interest rates on loans to the larger borrowers from business and industry. The phenomenon of cross-subsidization had got built into the system where concessional rates provided to some sectors were compensated by higher rates charged to non-concessional borrowers.

Objectives of Financial Reforms Introduced in 1991

1) To develop a market-oriented, competitive, world-integrated, diversified, autonomous, transparent financial system.
2) To increase the allocative efficiency of available savings and to promote accelerated growth of the real sector.
3) To increase or bring about the effectiveness, accountability, profitability, viability, vibrancy, balanced growth, operational economy and flexibility, professionalism and de-politicization in the financial sector.
4) To increase the rate of return on real investment.
5) To promote competition by creating level-playing fields and facilitating free entry and exit for institutions and market players.
6) To ensure that the rationalization of interest rates structure occurs, that interest rates are flexible, market-determined or market-related, and that the system offers to its users a reasonable level of positive real interest rates. In other words, the goal has been to dismantle the administered system of interest rates.

7) To reduce the levels of resource pre-emption and to improve the effectiveness of directed credit programs.
8) To build a financial infrastructure relating to supervision, audit, technology, and legal matters,
9) To modernize the instruments of monetary control so as to make them more suitable for the conduct of monetary policy in a market economy i.e., to increase the reliance on indirect or market-incentives based instruments rather than direct or physical instruments of monetary control.

Major Reforms After 1991 in Financial System

The reforms have had a broad sweep encompassing operational matters, banking, primary and secondary stock markets, government securities market, external sector policies, and the system as a whole. These have been classified into three areas: issues relating to creating a flexible banking system; development of institutions such as private sector banks and mutual funds; and monetary policy instruments such as interest rates, reserve ratios, and refinancing facilities. In other words, reforms relate to the issues of ownership and control, competition, and policy and regulation stance.

Systemic and Policy Reforms

1) Most of the interest rates in the economy deregulated; a beginning made to move towards market rates on government securities: the system of administered interest rates largely dismantled; and the structure of interest rates greatly simplified.
2) The preemption of banks' resources through SLR in favor of the government was brought down and the rate of return on SLR securities is maintained by and large at market rates. The SLR on incremental net domestic and time liabilities (NDTL) of banks reduced from 38.5 percent in 1991-92 to 24 percent now.
3) Capital adequacy norms for banks, financial institutions, and virtually all market intermediaries introduced. The Basel Committee framework for capital adequacy adopted.
4) A Board of Financial Supervision (BFS) with an advisory council and an independent department of supervision established in RBI.
5) Recovery of Debts Due to Banks and Financial Institutions Act, 1993 passed to set up Special Recovery Tribunals to facilitate quicker recovery of loan arrears.
6) In order to moderate or minimize the automatic monetization of the budget deficit, the agreement to impose a ceiling on the issue of ad hoc Treasury Bills (TBs) and to phase them out in due course signed by the Government of India (GOI) and RBI in September 1994. Subsequently, the system of ad hoc treasury bills abolished and replaced by the system of Ways and Means Advances effective April 1, 1997.
7) The private sector was allowed to set up banks, mutual funds, money market mutual funds, insurance companies, etc. Public sector banks permitted diversified ownership by law subject to 51 percent holding of government/RBI. SBI, IFCI and IRBI converted into public limited companies.
8) Capital Issues (Control) Act, 1947 repealed and the office of Controller of Capital Issues abolished.
9) Securities and Exchange Board of India (SEBI) made a statutory body in February 1992 and armed with necessary authority and powers for regulation and reform of the capital market.
10) Convertibility clause is no longer obligatory in the case of assistance sanctioned by term lending institutions.
11) Floating interest rate on financial assistance (linked to interest rate on 364 – day TBs) introduced by all-India development banks.

12) The Reserve Bank of India (Amendment) Act 1997 passed requiring all non-bank financial companies (NBFCs) with net-owned funds of Rs.25 lacs and more to register with the RBI.
13) Over the Counter Exchange of India (OTCEI) and the National Stock Exchange (NSE) with nation-wide stock trading and electronic display, clearing and settlement facilities established and made operational.

Banking Reforms

1) Interest rates on deposits and advances of all co-operative banks including urban cooperative banks deregulated. Similarly interest rates on commercial bank loans above Rs.2 lacs, and on domestic term deposits above two years, and Non-Resident (External) Rupee Accounts [NRNR] deposits decontrolled.
2) The State Bank of India and other nationalized banks enabled to access the capital market for debt and equity.
3) Prudential norms for income recognition, classification of assets and provisioning for bad debts for commercial banks, including regional rural banks and financial institutions introduced. They are required to adopt uniform and sound accounting practices in respect of these matters, and the valuation of investments. Banks are required to mark to market the securities held by them.
4) The Performance Obligations and Commitments (PO & C) obtained by RBI from each bank; they provide for essential quantifiable performance parameters which lay emphasis on increased but low-cost deposits, quality lending, generation of more income and profits, compliance with priority sectors and export lending requirements, improvement in the quality of investments, reduction in expenditure, and stepping up of staff productivity.
5) Banks required making their balance sheets fully transparent and making full disclosures in keeping with International Accounts Standards Committee.
6) Banks given greater freedom to open, shift, and swap branches as also to open extension counters.
7) The perceived constraints on banks such as prior credit authorization, inventory and receivables norms, obligatory consortium lending and curbs in respect of project finance relaxed.
8) The budgetary support extended for recapitalization of weak public sector banks.
9) Banking Ombudsman Scheme 1995 introduced to appoint 15 ombudsmen (by RBI) to look into and resolve customers' grievances in a quick and inexpensive manner. Most of the recommendations of Goiporia Committee in connection with improving customer service by banks implemented.
10) Banks set free to fix their own foreign exchange open position limit subject to RBI approval.
11) Loan system introduced for delivery of bank credit. Banks were required bifurcate the maximum permissible bank finance into loan component (short-term working capital loan) and cash credit component, and the policy of progressively increasing the share of the former introduced.

Primary and Secondary Stock Market Reforms

1) Primary issues to be made compulsory through the Depository Mode after a specified date.
2) 100 per cent Book Building in respect of issues of Rs. 25 crore and above.
3) Reduction in the number of mandatory collection centres in respect of issues above Rs. 10 crore to four metropolitan cities
4) A norm of five shareholders for every Rs.1 lac of fresh issues of capital and 10 shareholders for every Rs.1 lac of offer for sale prescribed as an initial and continuing listing requirement.
5) The payment of any direct or indirect discounts or commissions to persons receiving firm

allotment prohibited.

6) Debt issues not accompanied by an equity component permitted to be sold entirely by the book-building process.
7) Housing finance companies considered to be registered for issue purposes, provided they are eligible for refinance from the National Housing Bank.
8) Issuers were allowed to list debt securities on stock exchanges without their equity being listed. Mutual funds permitted to underwrite public issues.
9) The stock exchanges required to disclose, carry forward position scrip-wise and broker-wise at the beginning of carry forward session.
10) A ceiling of Rs.10 crore imposed on stock market members doing business of financing carry forward transactions.
11) Depositories Act, 1996 passed to provide a legal framework for the establishment of depositories to record ownership details in book entry form, and to facilitate dematerialization of securities.
12) Stock lending scheme without attracting capital gains introduced. Under this scheme, short sellers can borrow securities through an intermediary before making such sales.
13) Stock exchanges asked to modify listing agreements in order to provide for the payment of interest by companies to investors from the 30^{th} day of the closure of public issue.
14) All stock exchanges required to institute the buy-in or auction process.
15) Stock exchanges was asked to collect 100 percent daily margins on the notional loss of a broker for every scrip, to restrict gross traded value to 33.33 times the broker's base minimum capital, and to impose quarterly margins on the basis of concentration ratios.
16) The stock exchanges are being modernized; many of them have introduced electronic trading system; the Bombay Stock Exchange has started its on-line trading system, BOLT.
17) The Bombay Stock Exchange and other exchanges with screen-based trading system were allowed to expand their trading terminals to locations where no stock exchange exists and to others subject to an understanding with the local stock exchange.
18) Both short and long sales are required to be disclosed to the exchange at the end of each day, and they are to be regulated through the imposition of margins.
19) There are many other stock market reforms which have been introduced during the past five to six years.

Government Securities Market Reforms

1) A 364-day treasury bill (TB) replaced the 182-day TB in 1992-93, and it is being sold by fortnightly auction since April 1992.
2) Auction of 91-day TB commenced from January 1993.
3) Maturity period for new issues of Central government securities shortened from 20 to 10 years and that for state government securities from 15 to 10 years.
4) Funding of Auction TBs into fixed coupon dated securities at the option of holders introduced since April 19, 1993.
5) Six new instruments were introduced:
    i) zero coupon bonds on 18.1.94,
    ii) tap stock on 29.7.94,
    iii) partly-paid government stock on 15.11.94,
    iv) an instrument combining the features of tap and partly-paid stocks on 11-9-95,
    v) floating rate bonds on 29.9.95,
    vi) Capital indexed bonds in 1997.
6) State governments and provident funds allowed participating in 91-day TB auctions on a

non-competitive basis from August 1994.

7) A scheme for auction of government securities from RBI's own portfolio as a part of its open market operations announced in March 1995.
8) The institution of primary dealers in government securities market established and guidelines for them issued in March 1995.
9) A system of Delivery vs. Payment (DVP) in Subsidiary General Ledger (SGL) transactions introduced in Bombay in July 1995.
10) Reverse repo facility with RBI in government dated securities extended to Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI).

External Financial Market Reforms

1) Flexible exchange rate system introduced and exchange controls largely dismantled.
2) Foreign Institutional Investors (FIIs) allowed access to Indian capital market on registration with SEBI. FIIs permitted to invest up to 10 percent in equity of any company, to invest in unlisted companies, to set up pure (100 percent) debt funds, and to invest in government securities. Foreign endowment funds, university funds, foundations and charitable trusts/societies are allowed to register as FIIs.
3) Indian companies permitted to access international capital markets through various instruments including euro-equity issues.
4) The Union Budget 1997-98 proposed the replacement of Foreign Exchange Regulation Act (FERA), 1973 by a Foreign Exchange Management Act (FEMA) to facilitate easy capital flows.
5) Rupee made convertible on current account and a considerable progress made in introducing capital account convertibility.
6) The rate of long-term capital gains tax on portfolio investments by NRIs reduced from 20 percent to 10 percent and brought on par with the rate for FIIs.
7) NRIs, OCBs, FIIs permitted to invest up to 24 percent in equities of Indian companies engaged in all activities except those of agriculture and plantation.
8) In case of medium- and long-term external commercial borrowings (ECBs), on lending of the proceeds of development finance institutions to different borrowers at different maturities permitted.
9) Companies permitted to retain euro-issue proceeds as foreign currency deposits with banks and public financial institutions in India. Further, companies permitted to remit funds into India in anticipation of the use of funds for general corporate restructuring and working capital needs.
10) RBI made a single-window agency for receipt and disposal of proposals for overseas investments by Indian companies.

The Foreign Investment Promotion Board (FIPB) reconstituted and Foreign Investment Promotion Council (FIPC) set up to promote foreign direct investment in India.