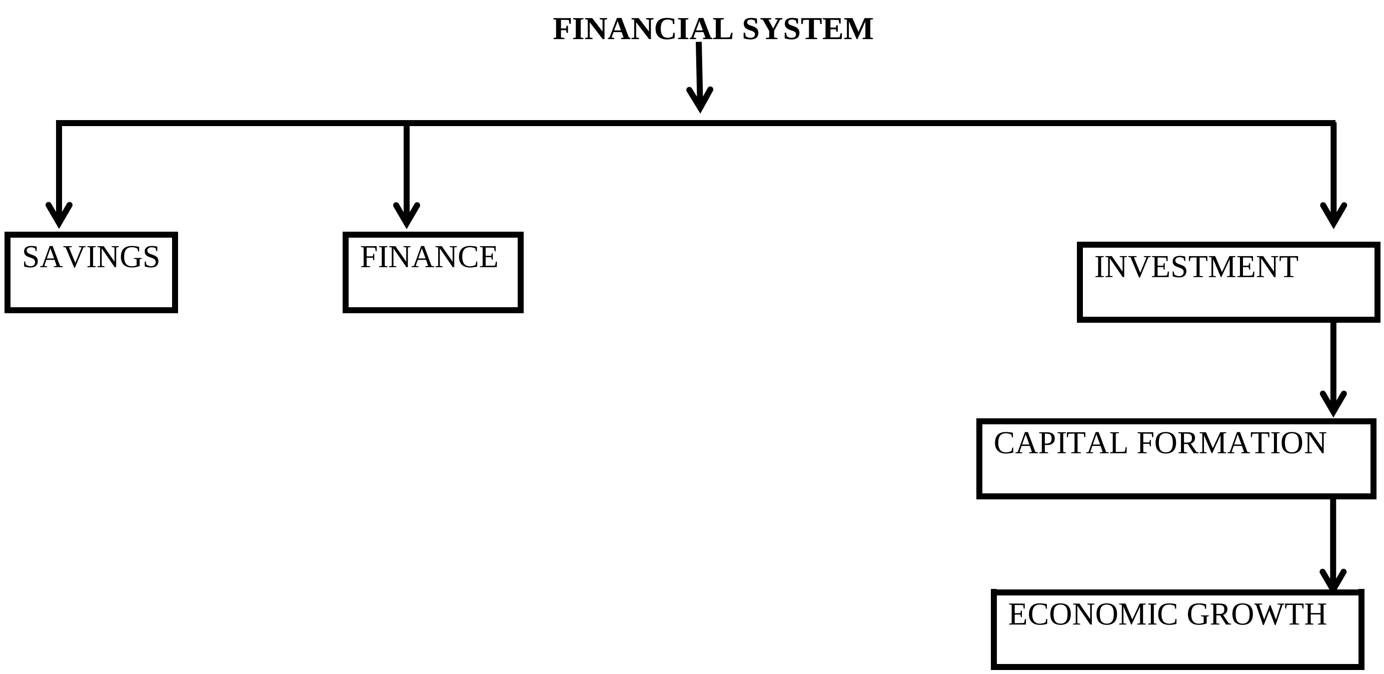
Indian Banking and Financial System Tips

1. Introduction to Financial System

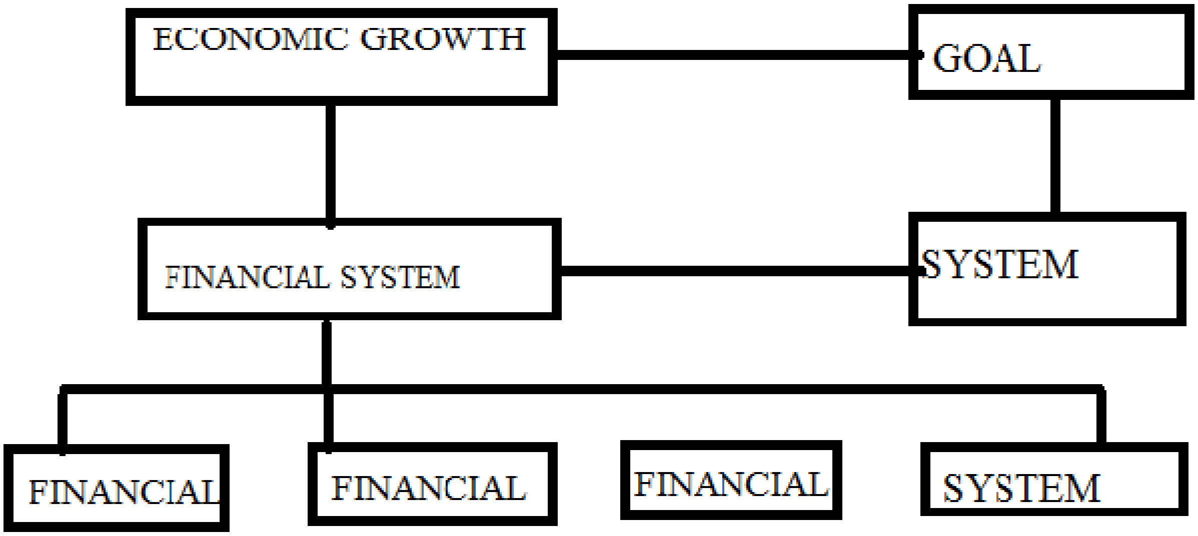
The economic scene in the post independence period has seen a sea change; the end result being that the economy has made enormous progress in diverse fields. There has been a quantitative expansion as well as diversification of economic activities. The experiences of the 1980s have led to the conclusion that to obtain all the benefits of greater reliance on voluntary, market-based decision-making, India needs efficient financial systems. 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.

1.1 Significance and Definition The term financial system is a set of inter-related activities/services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, investment capital formation and growth. Van Horne defined the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. Christy has opined that 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." From the above definitions, it may be said that the primary function of the financial system is the mobilisation of savings, their distribution for industrial investment and stimulating capital formation to accelerate the process of economic growth.



The Concept of the Financial System

The process of savings, finance and investment involves financial institutions, markets, instruments and services. Above all, supervision control and regulation are equally significant. Thus, financial management is an integral part of the financial system. On the basis of the empirical evidence, Goldsmith said that "... a case for the hypothesis that the separation of the functions of savings and investment which is made possible by the introduction of financial instruments as well as enlargement of the range of financial assets which follows from the creation of financial institutions increase the efficiency of investments and raise the ratio of capital formation to national production and financial activities and through these two channels increase the rate of growth……" The inter-relationship between varied segments of the economy are illustrated below:-



Inter-relationship in the Financial System

A financial system provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange reduces the costs of transactions. It facilitates trade and, therefore, specialization in production. Financial assets with attractive yield, liquidity and risk characteristics encourage saving in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables an economic agent to pool, price and exchange risks in the markets. Trade, the efficient use of resources, saving and risk taking are the cornerstones of a growing economy. In fact, the country could make this feasible with the active support of the financial system. The financial system has been identified as the most catalyzing agent for growth of the economy, making it one of the key inputs of development

1.2 The Organisation of the Financial System in India

The Indian financial system is broadly classified into two broad groups:

i) Organised sector and *(ii)* unorganised sector.

"The financial system is also divided into users of financial services and providers. Financial institutions sell their services to households, businesses and government. They are the users of the financial services. The boundaries between these sectors are not always clear cut.

In the case of *providers* of *financial services,* although financial systems differ from country to country, there are many similarities.

(i) Central bank
(ii) Banks
(iii) Financial institutions
(iv) Money and capital markets and
(v) Informal financial enterprises.

i) Organised Indian Financial System The organised financial system comprises of an impressive network of banks, other financial and investment institutions and a range of financial instruments, which together function in fairly developed capital and money markets. Short-term funds are mainly provided by the commercial and cooperative banking structure. Nine-tenth of such banking business is managed by twenty-eight leading banks which are in the public sector. In addition to commercial banks, there is the network of cooperative banks and land development banks at state, m district and block levels. With around two-third share in the total assets in the financial system, banks play an important role. Of late, Indian banks have also diversified into areas such as merchant banking, mutual funds, leasing and factoring.

The organised financial system comprises the following sub-systems:
1. Banking system
2. Cooperative system
3. Development Banking system
    (i) Public sector
    (ii) Private sector

4.Money markets and
5. Financial companies/institutions. Over the years, the structure of financial institutions in India has developed and become broad based. The system has developed in three areas - state, cooperative and private. Rural and urban areas are well served by the cooperative sector as well as by corporate bodies with national status. There are more than 4,58,782 institutions channellising credit into the various areas of the economy.

ii) Unorganised Financial System On the other hand, the unorganised financial system comprises of relatively less controlled moneylenders, indigenous bankers, lending pawn brokers, landlords, traders etc. This part of the financial system is not directly amenable to control by the Reserve Bank of India (RBI). There are a host of financial companies, investment companies, chit funds etc., which are also not regulated by the RBI or the government in a systematic manner. However, they are also governed by rules and regulations and are, therefore within the orbit of the monetary authorities.

Indigenous Banking in India

At independence, India had an indigenous banking system with a centuries-old tradition. This system had developed the hundi, a financial instrument still in use that is similar to the commercial bill of Western Europe. Hundi were used to finance local trade as well as trade between port towns and inland centers of production. They were often discounted by banks, especially if they were endorsed by indigenous bankers. Indigenous bankers combined banking with other activities, much as the goldsmiths, merchants, and shippers of eighteenth and nineteenth century Europe had done. They usually belonged to certain castes or communities, such as the Multanis, Marwaris and Chettiars, and they differed in the extent to which they relied on their own resources, rather than deposits and other funds for their lending. Indigenous bankers often endorsed hundis issued by traders and sometimes provided personal guarantees for loans from commercial banks. Such bankers were collectively known as Shroffs, a term that probably originally referred to money changers but over time came to refer to the more sophisticated and influential indigenous bankers. The main moneylenders were the Sowkars (who lent to farmers from their own resources or funds borrowed from the Chettiars and other indigenous bankers) and the Pathans (who lent mainly to poor people and often resorted to intimidation to ensure repayment). Indigenous banking was based on an elaborate and extensive network of personal relations that overcame the problems of dealing with a large number of customers. Brokers were used for making introductions and vouching for the creditworthiness of individual borrowers but did not offer personal guarantees. Some brokers specialized in introducing indigenous bankers to commercial banks, while others brought together traders and indigenous bankers.

Rural Financial System.

Rural financial system has been evolved over a period of time from the year 1904, when the first Primary Agricultural Credit Society was organized, by accepting and implementing important recommendations of expert committees appointed by the Government of India/RBI from time to time. During the pre-reform period, more particularly, after the advent of the scientific and technological revolution in the sphere of agriculture, the Government of India and the RBI have evolved several new concepts, innovations and novel approaches, which, the Rural Financial Institutions (RFls) have responded very favorably by implementing them.

The Banking System

The structure of the baking system is determined by two basic factors – economic and legal. The Development of the economy and the spread of banking habit calls for increasing banking services. The demand for these banking services affects the banks' structure and organisation. National objectives and aspirations result in government regulations, which have a profound influence on" the banking structure. These regulations are basically of two types. First, regulations which result in the formation of new banks to meet the specific needs of a group of economic activities. Secondly, legislation that affects the structure by means of nationalisation, mergers or liquidation.