EMERGING STRUCTURE OF INDIAN FINANCIAL SYSTEM

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The existence of an efficient and well-developed financial system is a necessary condition for economic development to take place. The Indian financial system has witnessed a phenomenal expansion in its geographical coverage and functional spread over the last few years thereby enabling a rapid growth of the corporate sector in India. Further, in a regime of financial sector reforms, the financial intermediaries, commercial banks, term-lending and investing institutions have been continually trying to bring about sophistication and innovations in their working. In view of this, the purpose of the present paper is to analyse the emerging structure of the Indian financial system in detail and interpret it in terms of the financial reforms undertaken in the Indian economy in recent years.

INTRODUCTION

The activity of saving in an economy is typically diffused across millions of individual households who lack the skill, capacity and temperament for active investment. In contrast, the act of investment is mainly confined to a special class of entrepreneurs and businessmen who possess the requisite competence but generally lack enough funds of their own to make the desired investment and hence are on the whole net deficit spenders. This clearly suggests that for productive investment and capital formation to take place, the savings in the economy should be somehow mobilised from the surplus units and in turn distributed among the genuine deficit spenders.

In this context, it is worth noting that at the micro level, an individual saver will find it exceedingly difficult and uneconomical to search for an investor for his small amount of savings. Moreover, a small saver will not generally be in a position to bear the risk of default arising out of such lending since he cannot be reasonably expected to fully ascertain the credit worthiness of the concerned deficit spender. Thus it follows that the enormous task of mobilising funds from a large number of savers in the economy in order to make them available to productive investors should be entrusted to a specialised institutional set-up that could effectively and efficiently carry out this responsibility. It is in fact this specialised set of institutional arrangements which is known as the *Financial System.* Thus construed, the financial system simply refers to the whole mechanism comprising financial assests, financial institutions and financial markets that ensure the transfer of financial resources in the economy from surplus savers to deficit investors.

In this context, Khan (1985) has observed that the financial system essentially acts as a link between savers and investors and thereby promotes economic development by bringing together the supply of savings and the demand for investible funds in the economy. Evidently, the growth of business

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Figure 1 : Number of Branches of Commercial Banks in India

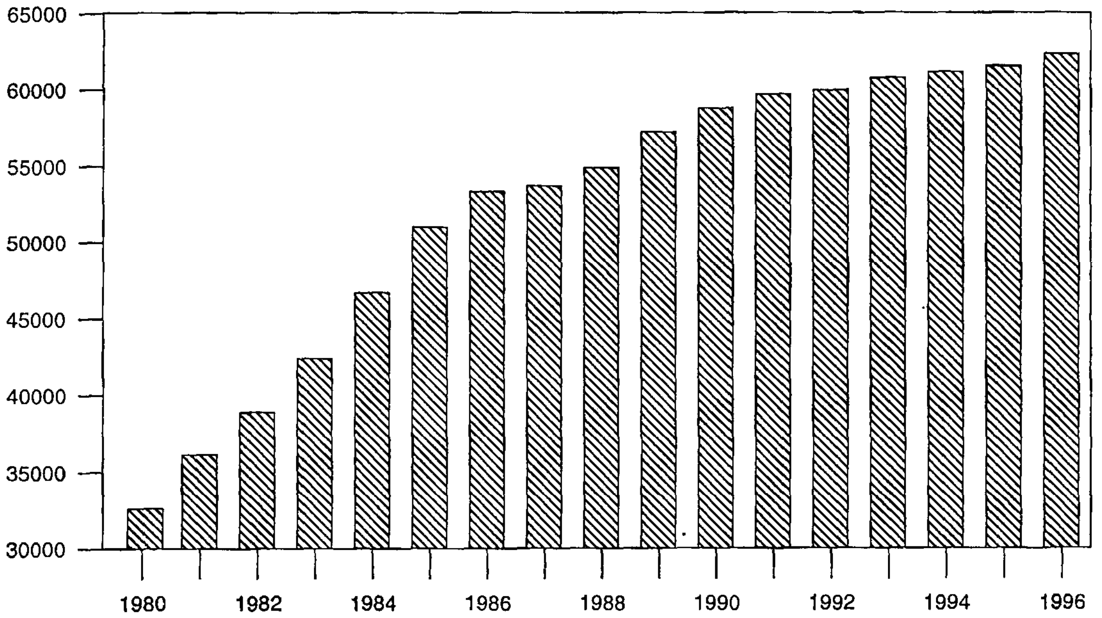
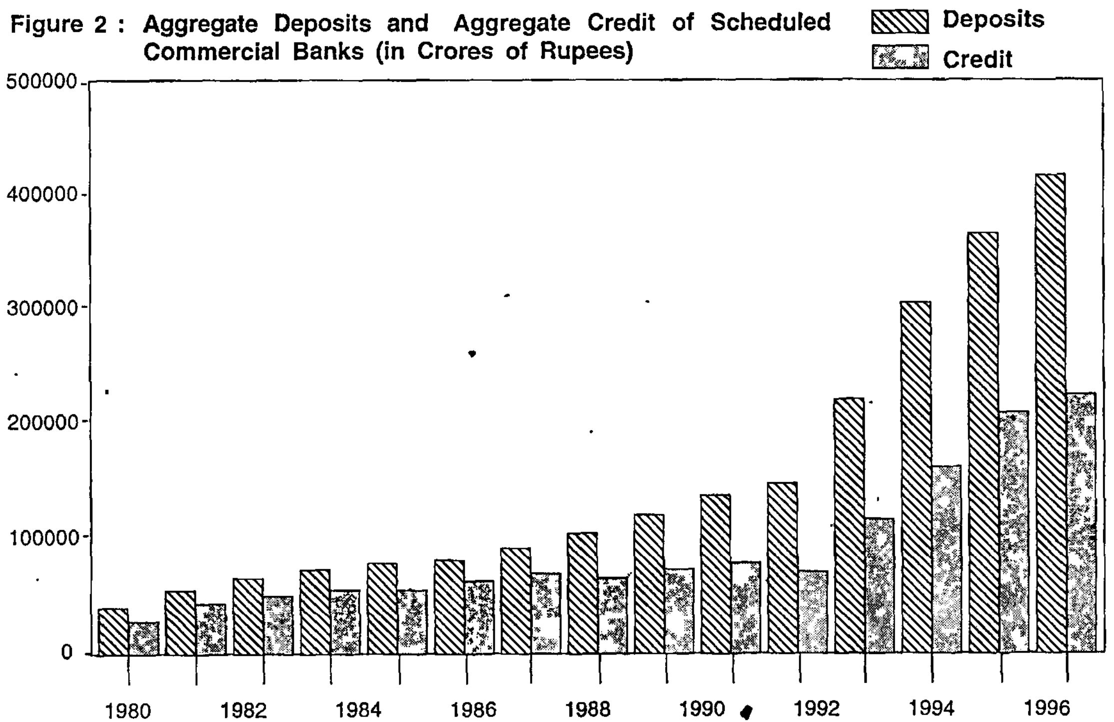


Figure 2 : Aggregate Deposits and Aggregate Credit of Scheduled Commercial Banks (in Crores of Rupees)



and corporate sector crucially hinges on the efficacy of the financial system since it is only through the medium of financial intermediaries and financial markets that the legitimate credit needs of entrepreneurs and investors could be suitably met.

Realising the significance of the financial system for the overall growth and development of the Indian economy, the monetary authority of India in recent years has tried to strengthen the financial sector by undertaking a number of reform measures aimed at adapting the financial system to the emerging needs and challenges of a competitive environment. The major inspiration and policy thrust for financial reforms came from the recommendations of the Narasimham Committee (1991) which was a high level committee appointed by the Government of India in 1991 with M. Narasimham, a former Governor of Reserve Bank of India, as its chairman to examine all aspects relating to the stucture, organisation, functions and procedures of the financial system.

In order to analyse the various facets of the process of financial reforms so as to appreciate the emerging trends and developments in the financial sector of the Indian economy, it is pertinent to have a closer look at the Indian financial system.

INDIAN FINANCIAL SYSTEM : AN OVERVIEW

The Indian financial system has witnessed a phenomenal expansion in its geographical coverage and functional spread over the last two decades. Consequently, it has made impressive quantitative achievements both on the front of resource mobilisation as also in the sphere of extending its credit reach over the concerned period as is clear from Figures 1 and 2 based on the data obtained from GOI (1996). In fact the rapid growth of the corporate sector in India was made possible in recent years only because of the active role played by different financial intermediaries such as commercial banks and their subsidiaries, non-banking financial corporations, term lending institutions, etc. According to Gupta (1997), the financial system of India can be broadly divided into three constituent parts, viz., financial assets, financial markets and financial institutions as shown in Figure 3. On closer examination, however, we find that these components are not independent as financial markets are nothing but credit markets dealing in financial assets and instruments of various kinds such as currency, deposits, cheques, bills of exchange, bonds, etc.

Thus the transactions pertaining to all types of financial assets are esentially covered under the operation of financial markets. Likewise, all financial institutions, whether they are Banks or Non-Bank Financial Intermediaries (NBFIs) always form a part of some specific financial market dealing in the borrowing and lending of funds.

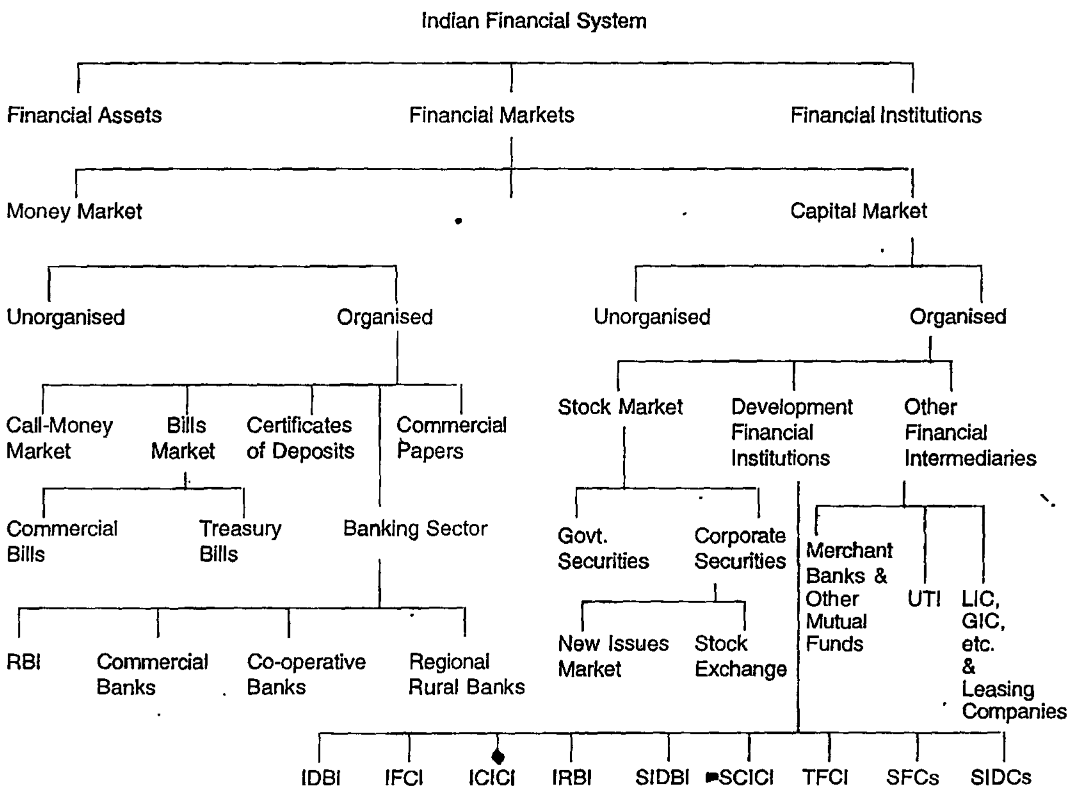
In view of this, the Indian financial system can be broadly identified with the system and functioning of finanical markets in India. Thus in order to better understand the working of the Indian financial system, it becomes imperative to carry out a detailed functional-cum-institutional classification of the financial markets in India as shown in Figure 3. As is clear from Figure 3, the Indian financial system basically consisits of two parts, namely the *Indian Money Market* and the *Indian Capital Market*. The money market essentially refers to the market in which short-term funds are borrowed and lent whereas the market for medium-term and long-term funds is known as the capital market. Structurally, both the money market and capital market in India can be further divided into their organised and unorganised

components wherein the latter sections, viz., the unorganised money and capital markets are practically insulated from the direct control of the monetary authority in the Indian economy. These unorganised segments of financial markets are primarily composed of private money lenders and indigenous bankers.

While the professional money lenders typically specialise in lending their personal funds, the indigenous bankers raise a part of their loanable funds from the public in the form of deposits. Similarly as opposed to the money lenders who invariably conduct their transactions in cash, most of the transactions of indigenous bankers are based on dealings in short-term credit instruments like *hundis* and internal bills of exchange. The indigenous bankers have been variously called as Shroffs, Seths, Sahukars, Mahajans, and Chettiars in different parts of the country. They have generally been observed to combine banking with trading and commission business. But owing to the rapid expansion of organised banking and financial sector coupled with a relative shrinkage of unregulated credit markets in the post-independence era, the quantitative significance of the unorganised money and capital markets is gradually declining in India.

Thus it would be reasonable to regard the contemporary Indian financial system as mainly comprising the organised credit and

Figure 3 : Functional-cum-Institutional Classification of the Indian Financial System



financial markets. That is to say, the present-day financial system in India can be primarily identified with organised money and capital markets. It is therefore pertinent to analyse the composition of these markets in detail.

In this context it is worth noting that the organised money market in India can be broadly decomposed into its various sub-markets such as inter-bank call money market, short-term bills market, the markets for certificates of deposits and commercial papers on the one hand and the organised banking sector on the other as shown in Figure 3. As is also clear from this figure, the short term bills market could either deal in commercial bills of exchange or instead in treasury bills. Similarly the organised banking system in India not only constitutes the Reserve Bank of India which is the central bank or apex institution in the Indian banking structure, but also includes the commerical banks, co-operative banks and regional rural banks supervised by it.

As far as the organised capital market in India is concerned, it can be broadly divided into the stock market dealing in either government or corporate securities, development financial institutions and other financial intermediaries such as merchant banks, Unit Trust of India and other mutual funds, General Insurance Corporation, leasing companies, etc., as is clear from Figure 3.

The market for government and semi-government securities backed by the RBI is known as the gilt-edged market. The securities traded in this market are stable in value and much sought after by the banks and other financial institutiions which are statutorily required to hold such securities by the RBI. It is for this reason that the Indian gilt-edged market is sometimes referred to as a capitve market. The market for corporate securities, i.e. industrial securities market can be further divided into the new issues market and the old capital market or the stock exchange. The new issues market refers to the raising of new capital in the form of shares and debentures whereas the old capital market deals in securities already issued by the companies.

Regarding development financial instituions, it is worth noticing that they are specialised financial institutions that perform the twin functions of providing medium and long-term finance to the private entrepreneurs along with carrying out various promotional activites conducive to economic development such as underwriting and the provision of technical and managerial consultancy.

As is evident from Figure 3, the most prominent development financial institutions operating at the all-India level are the Industrial Development Bank of India (IDBI), the Industrial Finance Corporation of India (IFCI), The Industrial Credit and Investment Corporation of India (ICICI), the Industrial Reconstruction Bank of India (IRBI) and the Small Industrial Development Bank of India (SIDBI). In addition, some specialised term-lending financial institutions such as Shipping Credit and Investment Corporation of India Ltd.(SCICI) and Tourism Finance Corporation of India (TFCI) also fall under this category. Futhermore, some institutions operating at the state level like State Fiancial Corporations (SFCs) and State Industrial Development Corporation (SIDCs) can also be included under the category of development financial institutions as shown in Figure 3.

EMERGING FINANCIAL SERVICES TO CORPORATE SECTOR

In view of the changing financial requirements of the corporate sector in

recent years, the financial intermediaries in India have not only expanded their business but also brought about sophistication and innovations in their working. As a result, the commercial banks and term lending institutions are no longer confined to their traditional financial services of providing short-term credit or term loans but they have assumed new roles and responsibilities by diversifying their services. For instance during the last few years, various financial services such as leasing, mutual funds, merchant banking, venture capital, factoring, consumer finance, investment counselling, etc., have come to the fore. Though some of these schemes were already in existence, yet they got a major fillip when many entrants got into the business due to liberalisation measures. Let us now briefly discuss some of the most prominent of these financial services that have emerged for the corporate sector in recent years.

Leasing

Leasing has emerged as an important source of long term financing of coporate enterprises during the last few years. A lease is an agreement under which a company acquires the right to make use of the asset without holding the title to it. A lease can be of two types, viz., *financial lease* and *operating lease.* A financial lease is a non-cancellable contractual commitment on the part of the lessee (the user) to make a series of payments to the lessor (the owner) for the use of an asset. The lessee will use and have control over the asset without holding the title to it. The lessee acquires most of the economic values associated with the outright ownership of the asset. The lessee is expected to pay for all maintenance, repairs and operating costs. The operating lease, in contrast, is a short term lease. The lease period is significantly less than the useful life of the concerned equipment. Lease facility is provided on a period to period basis and is usually cancellable on short notice.

Mutual Funds

A mutual fund is a fund in which investors pool their financial resources to invest in a diversified portfolio so as to spread and minimise the risk. It is a collective investment device whereby expert investment advice is provided and profits are equitably shared on the basis of respective share holding among its participants. Mutual fund companies employ their resources in such a manner as to provide their investors the combined benefits of low risk, steady return, high liquidity and capital appreciation.

From operational point of view, mutal funds are of two types, viz., open ended and close ended. If the period and/or the target amount of the fund is definite, the fund is called close ended, otherwise if it is indefinite then it is called open ended. Depending on investment needs of different investors, various types of mutual funds like income oriented fund, growth oriented fund, hybrid fund, high growth fund, etc., are in vogue.

Merchant Banking

Traditionally, merchant bankers acted as accepting houses and issuing houses. But in the contemporary context, merchant banking includes wide range of activities such as management of customers' securities, portfolio management, credit syndication, acceptance credit, promotional functions, counselling, etc. In performing these activities, a merchant banker acts as an intermediary, i.e. as an agency that transfers capital from those who own it to those who require it. In this way, the merchant banker helps in converting project ideas into industrial ventures.

Venture Capital

Venture capital refers to risk capital supplied to high tech growing companies particularly in the form of equity participation. It includes both start up capital and developmental capital. It is also a means of providing funds to turn research and development into commercial production.

Venture capital provides initial support to new companies using high technology and having potential for high profits but suffering from capital inadequacy and finding difficulty in raising funds through conventional methods of shares and debentures. The projects assisted by venture capital include the development of artificial intelligence software, three dimensional computer animation, digitised fonts, educational robots, energy conservation projects employing indigenous technology, export oriented and import substitution projects.

Factoring

Factoring service is an arrangement under which a commerical bank assumes credit control, protection and collection of debt for its clients, purchasing the receivables as they arise, maintaining sales ledger, attending to other book-keeping activities related to such accounts along with performing other ancillary functions. A businessman can obtain cash for invoices he sends to customers in repect of supply of goods and services. In other words, it is the sale of invoice to a bank and the client no longer carries factored accounts receivbles on his balance sheet. Factoring service differs from the existing facility of purchasing/discounting receivables in the sense that under the former, the bank finance is extended without recourse to the seller whereas in the latter , the finance provided by a bank is with recourse to the supplier who bears the risk of default by the debtor.

The importance of factoring service in India can be judged from the fact that with the growing industrialisation and increase in production and sales, the collection of debt is posing a serious problem. It has been observed that the average collection period is on the rise in recent years thereby resulting in an increase in the cost of financing book debts. Factoring services can go a long way in solving this problem as the factoring arrangement is normally on a continuous basis. As new receivables arise they are regularly sold to the factor and the proceeds are put at the client's disposal in his account. Often clients are prepaid upto 80 per cent of the value of the invoice and sometimes they are given the privilege of over-drawals from the account maintained with the factor.

RECENT FINANCIAL REFORMS

The existing structure of the Indian financial system has emerged out of the sustained process of financial reforms carried out in the Indian economy since the early nineties. As pointed out by Jadhav (1994), once the process of reforms of the real sector of the Indian economy took off, it was widely realised among the responsible sections of the society that such a process of economic reforms would remain incomplete until it is also supplemented by the reform of the financial sector.

The main inspiration and policy guidance for financial reforms was provided by the Narasimham Committee on the financial system which submitted its report in November 1991. This Committee was primarily interested in improving the financial health of the public sector banks and development financial institutions so as to make them viable and efficient in meeting the emerging needs of the economy. Towards this end, this Committee stressed on a greater market orientation and

contended that the solvency, health and efficiency of the financial institutions should be central to any effective programme aimed at financial reform. It was essentially on the recommendations of the Narasimham Committee that interest rates were deregulated and the statutory liquidity ratio was reduced in the Indian economy.

It is worth noting that just like the money market, even the capital market in India has experienced a number of reforms in recent years as a result of the deliberate attempts on the part of planners and policy makers. It was widely recognised that capital markets play a key role in the economy as a source of investible funds for the corporate sector. Thus the monetary authority carried out the process of capital market reform along with developing an effective regulatory framework aimed at improving market efficiency, making stock market transactions more transparent, curbing unfair trade practices and bringing the capital market up to international standards. The National Stock Exchange which started functioning in 1995 with its screen based and scripless trading system can be regarded as a milestone in the development of the Indian capital market.

The business of stock exchanges and other securities market is now being regulated effectively by the SEBI, i.e. Securities and Exchange Board of India which was given a statutory status and powers through an ordinance promulgated on January 30, 1992.

Some of the noteworthy developments in the primary market during 1992-93 to 1995-96 are as follows : (1) Merchant banking is brought under SEBI's regulatory framework and a code of conduct is issued; (2) The 'Banker to the Issue' is brought under the purview of SEBI for investor protection; (3) Companies are required to disclose all material facts and specific risk factors associated with their projects while making public issues; and (4) To discourage the use of stock-invest by institutional investors, the facility has been restricted to mutual funds and individual investors.

Likewise, some of the secondary market reforms brought about during 1992-93 to 1995-96 are as follows : (1) UTI is brought under the regulatory jurisdiction of SEBI; (2) Private mutual funds are permitted and all mutual funds are allowed to apply firm allotment in public issues; (3) Stock exchanges are allowed to introduce carry forward system only with the prior permission of SEBI and subject to effective monitoring and surveillance system; and (4) The Depositories Ordinance promulgated in September 1995 is to provide a legal framework for the establishment of depositories to record ownership details in book entry form.

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