

# INDIAN FINANCIAL SYSTEM

**FINANCIAL SYSTEM** is an economic arrangement wherein financial institutions facilitate the transfer of funds and assets between borrowers, lenders, and investors.

A financial system is a **set of institutions and practices that facilitate and allow for the exchange of funds between borrowers, lenders and investors**. Financial systems exist on firm-specific, regional and global levels.

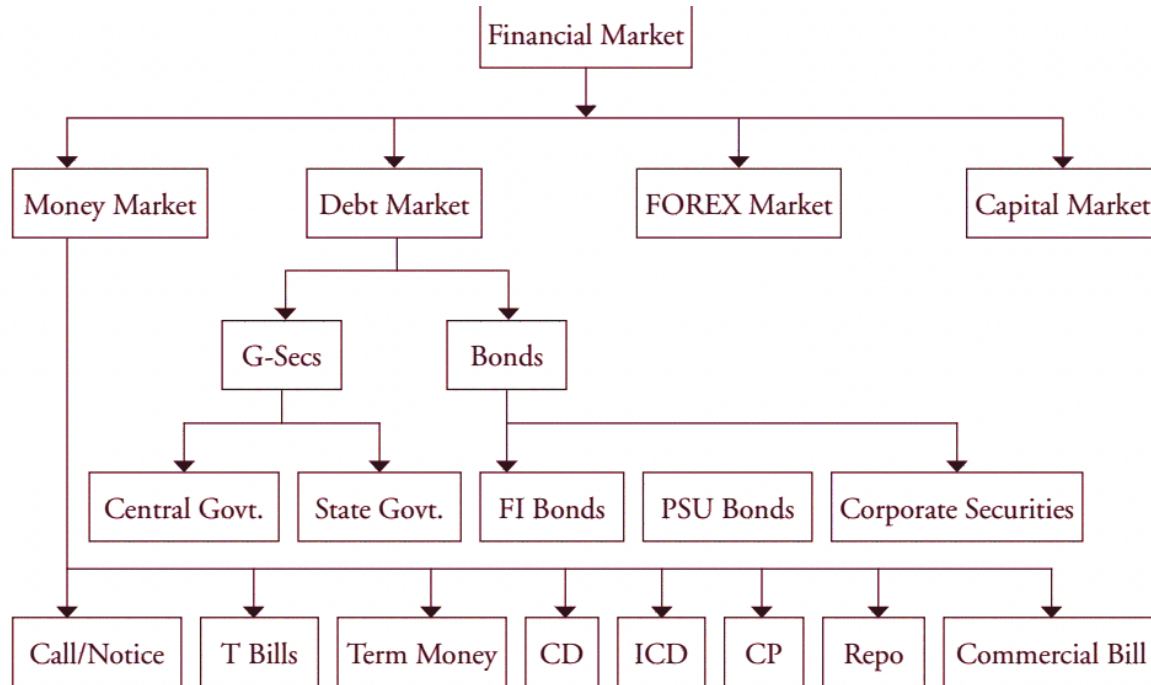
**They include institutions like:**

- Banks
- Government treasuries
- Insurance companies
- Loan companies
- Mutual funds
- Stock exchanges

The financial system comprises a **mixture of intermediaries, markets and instruments that are related to each other**. It provides a system by which, savings are transformed into investments.



## SEGMENTS OF THE FINANCIAL MARKET



## Financial System

Central Banking Authority	Capital Regulatory Authority	Insurance And Pension Regulation
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Central Banking Authority	Capital Market Regulatory Authority	Insurance and Pension Regulators
Monetary control	Equity market and debt market supervision	Regulatory frameworks including rules and regulations for running insurance business.
<b>Supervision over:</b> <ul style="list-style-type: none"> <li>Commercial banks</li> <li>NBFCs</li> <li>Primary Dealers</li> <li>Financial Institutions</li> <li>Co-operative banks</li> <li>Clearing and settlement system</li> </ul>	<b>Supervision over:</b> <ul style="list-style-type: none"> <li>Stock exchanges</li> <li>Brokers</li> <li>Equity and debt raisers</li> <li>Investment bankers (merchant bankers)</li> <li>Foreign Institutional Investors</li> </ul>	Supervising all insurance companies, both in life and general business

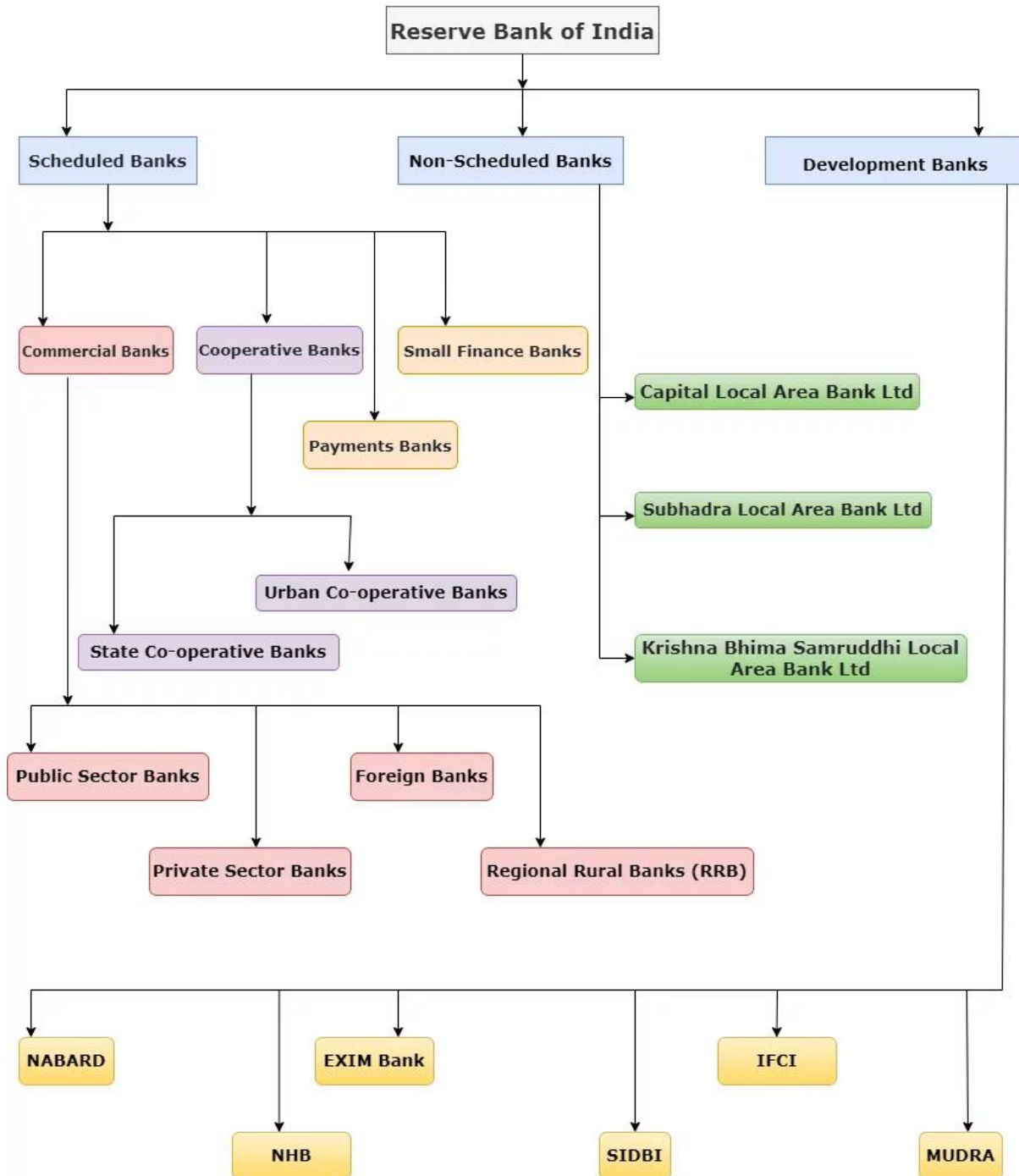
a) Management of Govt. Debt	<ul style="list-style-type: none"> <li>• Custodians</li> <li>• Depositories</li> </ul>	1) Regulating pricing, investments, and cost structure of insurance companies
b) Banker to Govt.	<ul style="list-style-type: none"> <li>• Mutual Funds</li> </ul>	2) Regulating insurance brokers including agencies both individuals and banks <b>Pensions:</b> 1. Framing rules for pension funds 2. Regulating all pension funds
c) Lender of last resort to banks	<ul style="list-style-type: none"> <li>• Listed Companies</li> </ul>	
d) Regulating money markets through monetary instruments including CRR, SLR. Repo rate, Bank rate, MSF	<ul style="list-style-type: none"> <li>• Service providers to capital markets like registrars</li> </ul>	

## ROLES AND FUNCTIONS OF THE CENTRAL BANKING AUTHORITY

- The Central Banking Authority (Reserve Bank of India) has two distinct roles;
- **Monetary control** including controlling of inflation and regulating the **functioning of banks** and also **NBCs except Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies**

Engaged in the business of **stock-broking/sub-broking, Venture Capital Fund Companies, Nidhi Companies, Insurance companies and Chit Fund Companies**, as these NBCs have been exempted from the requirement of **registration under Section 45-IA of the RBI Act, 1934** subject to **certain conditions**.





## Commercial Banks

- Banking system includes public sector banks, foreign banks, and private sector banks.
- As defined by the Banking Regulation Act (section 5.B), "Banking" means accepting, **for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.**
- The tools used by the Reserve Bank of India for regulation of commercial banks **include statutory and prudential regulations, other regulatory guidelines and moral suasion through speeches of Governor, Deputy Governors and periodic meetings, seminars, etc.**

## Co-operative Banks

- The rural co-operative credit system in India is **primarily mandated to ensure flow of credit to the agriculture sector.**
- It comprises of short-term and long-term co-operative credit structures.
- The short-term co-operative credit structure operates with a three-tier system - **Primary Agricultural Credit Societies (PACS) at the village level, Central Cooperative Banks (CCBs) at the district level and State Cooperative Banks (StCBs) at the State level.**
- **Primary Cooperative Banks (PCBs), also referred to as Urban Cooperative Banks (UCBs), cater to the financial needs of customers in urban and semi-urban areas.**

## **THE SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)**

The Securities and Exchange Board of India was established on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992.

SEBI was given additional statutory power by the **Government of India through an amendment to the Securities and Exchange Board of India Act, 1992.**

Prior to this, it was a non-statutory body and hence had no statutory powers vested in it.

### **Functions of SEBI -**

- Protective functions.
- Developmental functions.
- Regulatory functions.

### **Protective Functions**

- To protect the interests of investors **in securities and to promote the development of, and to regulate the securities market and also matters connected therewith.**
- To **check price rigging so as to avoid fraud and cheating which can happen to any investor.**
- To prohibit insider trading.
- To issue guidelines to protect the interests of investors.

### **Developmental functions**

- It promotes training of intermediaries of the securities market.





- It has initiated a flexible approach e.g. **investors can undertake internet trading through registered stockbrokers. Underwriting is now optional to reduce the cost of issue, etc.**

### **Regulatory functions**

- **Rules and regulations and a code of conduct have been framed to regulate the functioning of intermediaries** such as merchant bankers, brokers, underwriters, etc.
- To register and regulate the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers
- To register and regulate the working of mutual funds etc.
- To conduct inquiries and audit of stock exchanges
- To approve by-laws of stock exchanges.
- To **inspect the books of account and call for periodical returns** from recognized stock exchanges.
- To **register and regulate working of depositories, custodians of securities**. Foreign Institutional Investors, credit rating agencies etc.

### **NATIONAL HOUSING BANK (NHB)**

- National Housing Bank (NHB), was set up on 9<sup>th</sup> July 1988 under the National Housing Bank Act, 1987.
- It is a wholly owned subsidiary of RBI.
- The entire paid up capital of NHB is contributed by RBI.

It should operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support incidental to such institutions.

NHB registers, regulates and supervises Housing Finance Company (HFCs), keeps surveillance through On-site & Off-site mechanisms and co-ordinates with other Regulators.

Functions of NHB :

- Regulatory
- Financial support
- Promotion and development

#### a) Regulatory functions

- NHB has been empowered to **determine the policy and give directions to the housing finance institutions and their auditors.**
- It has issued guidelines for **Asset Liability Management System in Housing Finance Companies.**
- It has put in place a system of **registration of housing finance companies.**
- It supervises the housing finance sector through a system of on-site and off- site surveillance.

#### b) Financial support

NHB supports the housing finance sector by providing.

- **Refinance to different primary lenders** in respect of eligible housing loans extended by them to individual beneficiaries.
- Refinance for project loans extended by them to various implementing agencies,
- Direct finance to projects undertaken by public housing agencies for housing construction and development of housing related infrastructure,



- **Guaranteeing the repayment of principal and payment of interest on bonds** issued by Housing Finance Companies, and
- Acting as a Special Purpose Vehicle for securitising the housing loan receivables.

### c) Promotion and Development

- It acts as a facilitator in promoting housing finance institutions.
- NHB has **issued the Model Memorandum and Articles of Association** and has also issued guidelines for participating in the equity of housing finance companies.
- All housing finance companies **registered with NHB u/s 29A of the National Housing Bank Act, 1987** and all scheduled commercial/co-operative banks are eligible for **refinance support from NHB subject to certain terms and conditions.**
- As a part of its promotional role, NHB has also formulated a scheme for guaranteeing the bonds to be issued by the housing finance companies.
- It meets the **requirement of trained personnel for the housing finance sector**, NHB has designed and conducts various training programmes.

## **Insurance Regulatory and Development Authority (IRDA)**

- The IRDA was constituted as an autonomous body in April, 2000 by passing IRDA Act, 1999.
- The IRDA was **constituted to regulate and develop the business of insurance and reinsurance in India.**



- The objectives of the IRDAI are two-fold, viz., policyholder protection and healthy growth of the insurance market

### Structure

- Government stake in the insurance Companies to be brought down to **50%**.
- Government should take over the **holdings of GIC and its subsidiaries** so that these subsidiaries can act as independent corporations.
- All the insurance companies should be given **greater freedom** to operate.

### Competition

- Private Insurance Companies with a minimum paid up capital of **Rs. 100 crores** should be allowed to enter the industry.
- No company should deal in both Life and General Insurance through a single entity.
- **Foreign companies** may be allowed to enter the industry, in **collaboration with the domestic companies**.
- **Postal Life Insurance** should be allowed to operate in the rural market.
- Only one State Level Life Insurance Company should be allowed to operate in each state.
- An Insurance Regulatory Body should be set up.

### Investment

- Mandatory Investments of LIC Life Funds in government securities to be **reduced from 75% to 50%**.
- GIC and its subsidiaries are not to hold more than 5% in any company.



## Customer Service

- LIC should **pay interest** on delays in payments **beyond 30 days**.
- Insurance companies must be encouraged to set up **unit linked pension plans**.
- Computerisation of operations and updating of technology to be carried out in the insurance industry.

## Organisational Structure of IRDAI

- IRDA is headed by a full time Chairman
- **five whole time** Members and **four part time** Members, all of whom are **appointed by the Government**.

## DUTY, POWERS AND FUNCTIONS

IRDA has the duty to regulate, promote and ensure an orderly growth of the insurance business and reinsurance business.

### The powers and functions of the IRDAI include:

- Issuing to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration.
- Protection of the interests of the policy holders.
- Specifying requisite **qualifications, code of conduct and practical training** for intermediary or insurance intermediaries and agents;
- Promoting and regulating professional organisations connected with the insurance and reinsurance business;
- Undertaking **inspection** of, conducting enquiries and **investigations** including audit of the insurers, intermediaries, other organisations connected with the insurance business;



- Specifying the **form and manner** in which **books of account** shall be maintained by insurers and other insurance intermediaries;
- Regulating **investment of funds** by insurance companies;
- Adjudication of **disputes between insurers and intermediaries** or insurance intermediaries

### **ENTITIES REGULATED BY IRDA**

**Entities that are regulated by IRDA are as follows:**

- Life Insurance Companies - Both public and private sector Companies
- General Insurance Companies - Both public and private sector
- Re-insurance Companies
- Agency Channels
- Insurance intermediaries

## **PENSION FUND REGULATORY AND DEVELOPMENT AUTHORITY (PFRDA)**

- The Pension fund regulatory and development authority was established in the year **2003**.
- The body was set up with a view to **promoting, regulating and developing the pension sector in the country**.
- PFRDA comes under the jurisdiction of the **Ministry of Finance**.

### **Functions :**

- To protect pension fund subscriber's interest
- Promote, Regulate, and Develop pension funds
- National Pension Scheme is governed under the PFRDA



- To promote the purchase of pension schemes in order to cater to senior citizen's financial needs.
- PFRDA performs the function of appointing various intermediate agencies like **Pension Fund Managers, Central Record Keeping Agency (CRA)**,
- Train and inform intermediaries about the pension schemes and their functioning.
- PFRDA helps in **educating the citizens** about the importance of pensions in old age.
- Addresses any grievances related to pension schemes
- Resolves disputes between various intermediaries

### **REFERRAL SERVICES**

There is no objection to banks offering referral services to their customers for financial products subject to the following conditions:

- a) The bank/third party issuers of the financial products should strictly adhere to the Know Your Customer (KYC)/Anti-Money Laundering (AML) guidelines in respect of the customers who are being referred to the third-party issuers of the products.**
- b) 'The bank should ensure that the selection of third-party issuers of the financial products is done in such a manner so as to take care of the reputational risks to which the bank may be exposed to in dealing with the third party issuers of the products.
- c) The bank should make it explicitly clear upfront to the customer that it is providing purely a referral service strictly on a non-risk participation basis.**

- d) The third-party issuers should adhere to the relevant regulatory guidelines applicable to them.
- e) While offering referral services, the bank should strictly adhere to the relevant RBI guidelines.

## **NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD)**

- A committee was constituted by **RBI to review the arrangements for institutional credit for agriculture and rural development (CRAFICARD) on 30 March 1979.**
- The committee under the Chairmanship of Shri B. Sivaraman, former member of Planning Commission, Government of India, in its interim report, recommended the need for a new organisational set up and recommended the formation of National Bank for Agriculture and Rural Development (NABARD).
- **NABARD came into existence on 12 July 1982 by transferring the agricultural credit functions of RBI and refinance functions of the then Agricultural Refinance and Development Corporation (ARDC).**
- NABARD was dedicated to the service of the nation by the late Prime Minister Mrs. Indira Gandhi on 05 November 1982.

It is the apex institution concerned with the policy, planning and operations in the field of agriculture and other rural economic activities.



## ROLE AND FUNCTIONS

In order to build an empowered and financially inclusive rural India, NABARD has specific departments that work towards the desired goals. These departments can be collectively categorized into three major units:

- Financial
- Developmental
- Supervision
- 

**Credit Functions:** NABARD acts as an apex body for meeting the credit needs of all types of agricultural and rural development.

- Framing policy and guidelines for rural financial institutions.
- Providing credit facilities to concerned institutions.
- Monitoring the flow of rural credit.
- Finalisation of annual credit plans of all districts for identification of credit deployment.
- Providing refinance facilities to State Co-operative Banks (SCBs), Land Development Bank (LDBs), Regional Rural Banks (RRBs) and other approved financial institutions for financing rural economic activities.

## Development Functions

- **Monitoring implementation of development action plans of banks.**
- **Providing financial support for the training institutes of cooperative banks, commercial banks and Regional Rural Banks.**
- **Providing financial assistance to cooperative banks for improved management information system, computerisation of operations and development of human resources.**



## Supervisory Functions

- Undertakes inspection of (RRBs) and Cooperative Banks (other than urban/primary cooperative banks) under the provisions of Banking Regulation Act, 1949.
- Undertakes inspection of State Cooperative Agriculture and Rural Development Banks (SCARDBs) and apex non-credit cooperative societies on a voluntary basis.
- Provides recommendations to Reserve Bank of India on issue of licenses to Cooperative Banks, opening of new branches by State Cooperative Banks and (RRBs).
- **Undertakes portfolio inspections besides off-site surveillance of Cooperative Banks and (RRBs).**

## **NON-BANKING FINANCIAL COMPANIES (NBCs)**

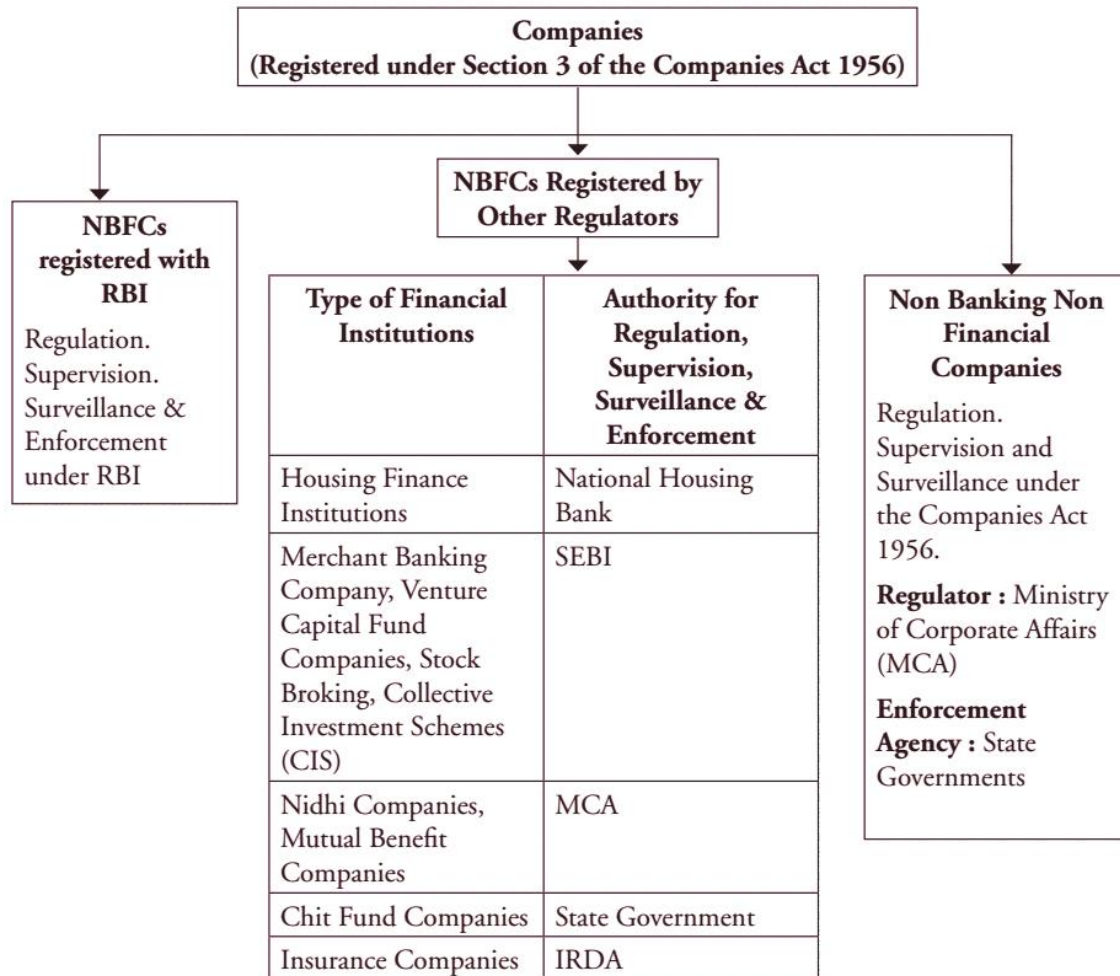
In India, we have financial institutions **which are not banks but which accept deposits and extend credit like banks.** These are called Non-Banking Financial Companies (NBFCs).

A Non-Banking Financial Company (NBFC) is a non-banking institution, which is a company **registered under the Companies Act** and is engaged in the **business of loans and advances, acquisition of shares/ stocks/ bonds/ debentures/ securities** issued by Government or local authority or other marketable securities of a like **nature, leasing, hire-purchase, insurance business, chit business etc.** but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

The functioning of the NBCs, which undertake financial activity in the form of accepting deposits, lending and making investments, is different from banks for reasons stated below-

- NBCs **cannot accept demand deposits;**
- NBFCs **do not form part of the payment and settlement system and cannot issue cheques drawn on itself;**
- The deposit insurance facility of **Deposit Insurance and Credit Guarantee Corporation is not available** to depositors of NBCs, unlike in case of banks.

### Overview of Regulators of Non-Banking Companies



## PRIMARY DEALERS

- In 1995, the Reserve Bank of India (RBI) introduced **the system of Primary Dealers (PDs) in the Government Securities (G-Sec) Market.**
- The objectives of the **PD system** are to **strengthen the infrastructure in G-Sec market, development of underwriting and market making capabilities for G-Sec, to improve the secondary market trading system**



and to make PDs an effective conduit for Open Market Operations (OMO).

- Primary dealers are entities **registered with the RBI and are licensed to purchase and sell government securities.**
- The scheduled commercial banks (except Regional Rural Banks) have also been permitted to undertake PD business departmentally from 2006-07.
- As on 1st July, 2016, there were seven standalone PDs and fourteen banks authorized to undertake PD business departmentally.

### **Facilities from RBI to PDs**

The RBI currently extends the following facilities to PDs to enable them to fulfil their obligations effectively:

- Access to **Current Account facility with RBI**
- Access to Subsidiary General Ledger (GL) Account facility with RBI;
- Access to **e-Kuber facility for primary auction;**
- Permission to **borrow and lend in the money market including call money market and to trade in all money market instruments;**
- Memberships of **electronic dealing, trading and settlement systems (NDS platforms/INFINET/RTGS/CCIL);**
- Access to the **Liquidity Adjustment Facility (LAF) of RBI;**
- Access to liquidity support from RBI under a scheme separately notified for standalone PDs;
- Access to OMO by RBI.

## • **FOREIGN INVESTMENTS IN INDIA**

- For growth of an economy, capital is one of the most important elements. **The capital requirements cannot be met from internal resources alone.**
- For this purpose, **countries turn to foreign investors to supply capital.**

Foreign capital can be used to develop infrastructure, set up manufacturing facilities and service hubs, and for investment in other productive assets, such as machinery and equipment, which contribute to economic growth and stimulates employment.