FINANCIAL SYSTEM

⇒ A 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:

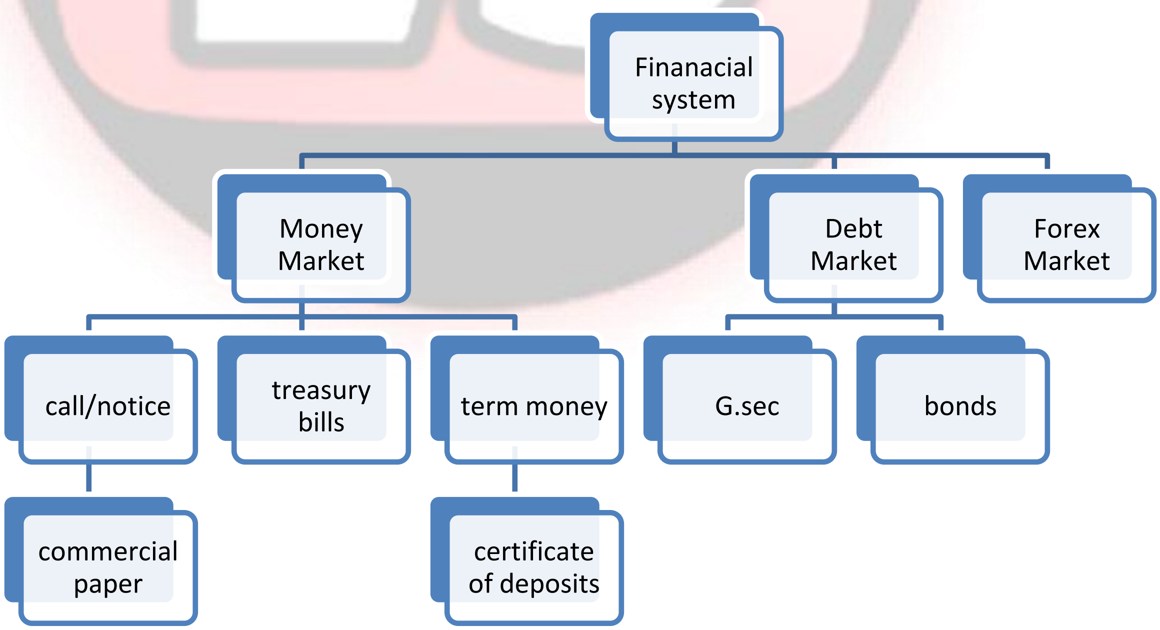
- Banks
- Government treasuries
- Insurance companies
- Loan companies
- Mutual funds
- Stock exchanges

A financial system means the structure that is available in an economy, in order to mobilize the capital from various surplus sectors of the economy and allocate and distribute the same to the various needy sectors.

The transformation of 'Savings into Investments and Consumption is facilitated by the active role played by the financial system. The process of transformation is aided by various types of financial assets suiting to the needs and demands of individuals - both the 'investors' and 'spenders. The offering of these diverse types of financial assets is supported by the role of 'financial intermediaries', who mediate between these two segments of investors and spenders.

Examples of intermediaries are banks, financial institutions, mutual funds, etc. The place where these activities take place could be taken to connote the financial market.

⇒ 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.



⇒ Money Market
⇒ Debt Market
⇒ Forex Market
⇒ Capital Market

a) Money Market:

- Call/Notice
- Treasury Bills
- Term Money
- Certificate of Deposits
- Inter Corporate Deposits (ICD)
- Commercial Papers
- Repo
- Commercial Bills

b) Debt Market:

i. G. Sec.

- Central Government
- State Governments

ii. Bonds

- FI Bonds*
- PSU Bonds
- Corporate Securities

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Financial System

Central Banking Authority	Capital Market Regulatory Authority	Insurance and Pension Regulators
1) Monetary control	1) Equity market and debt market supervision	1) Regulatory frameworks including rules and regulations for running insurance business.
a) Supervision over: • Commercial banks • NBFCs • Primary Dealers • Financial Institutions • Co-operative banks • Clearing and settlement system	2) **Supervision over**: • Stock exchanges • Brokers • Equity and debt raisers • Investment bankers (merchant bankers) • Foreign Institutional Investors	2) Supervising all insurance companies, both in life and general business

a) Management of Govt. Debt	• Custodians • Depositories	3) Regulating pricing, investments, and cost structure of insurance companies
b) Banker to Govt.	• Mutual Funds	4) Regulating insurance brokers including agencies both individuals and banks
c) Lender of last resort to banks	• Listed Companies	
d) Regulating money markets through monetary instruments including CRR, SLR. Repo rate, Bank rate, MSF	• Service providers to capital markets like registrars	**Pensions:** 1. Framing rules for pension funds 2. Regulating all pension funds

Reserve Bank of India as a Central Banking Authority

⇒ The Reserve Bank of India (RBI) takes its name from the Banking Regulation Act, 1949, **formerly known as the Banking Companies Act, 1949.** Regional rural banks, cooperative banks, Commercial banks, local area banks, non-banking financial companies and development financial institutions (DFIs) make up India's financial system.

⇒ The Central Banking Authority (Reserve Bank of India) has two different roles; Monetary control including **controlling inflation and bank supervision**

⇒ Reserve Bank along with Government of India is responsible for the **design, production and overall management of the nation's currency, with the goal of ensuring an adequate supply of clean and genuine notes.**

⇒ Reserve Bank acts as **lenders of last resort to banking system** and are responsible for putting in place an efficient payment and settlement system.

Functions of RBI

⇒ *Payment And Settlement System*

- An efficient and effective Payment and Settlement System is a necessary condition for smooth functioning of the Financial System.
- **Maintenance of clearing houses at various centres, creation of currency holding chests** in different geographical areas and creation of the mechanism for electronic transfer of funds are other activities undertaken by the Central Banks.

⇒ *Management of Government Debt*

- Most of the Central Banks manage the issue and service of government debt.
- This involves **price discovery, volumes to be raised, tenure of debt and matching it with the overall cash management of the debt.**

⇒*Bankers to Government*

- As a banker to the government central banks carries out certain banking functions to the government. It **holds custody of the cash balance of the government, gives temporary loans to both central and state governments and manages the debt operations of the central government**.
- The Government also deposits **its cash balances with the Reserve Bank**. The Reserve Bank may also, by agreement, act as the banker and debt manager to State Governments.

⇒*Lender of Last Resort to Banks*

- Commercial banks at times face financial crises and at that time are unable to get funds from any other sources.
- In this situation, they seek funds from the central bank in order to tide over the crisis. In India, RBI (Reserve Bank of India) is the central bank and saves commercial banks from bankruptcy.
- Due to this reason, RBI is known as the lender of last resort.

⇒*Inflation control:*

a) **Cash Reserve Ratio (CRR)**

- It is the **percentage of deposits that a bank has to keep as reserves** with the RBI.
- When the Government increases CRR, the bank has to keep a larger percentage of its deposits as reserves. It has lesser funds available to lend. It's capacity to lend decreases. Hence, the money supply also decreases. (CRR ↑ ⇒ money supply ↓).

b) **Statutory Liquidity Ratio (SLR)**

- It is the percentage of deposits that a bank has to invest in risk-free assets such as cash, gold, or Government securities.
- When the Government increases SLR, the bank has to keep a larger percentage of its deposits in cash, gold, and Government securities. It has a lesser amount to lend to consumers and businesses. Hence, the money supply decreases. (SLR ↑ ⇒ money supply ↓).

⇒*Financial Inclusion and development*

- This role encapsulates the essence of renewed national focus on Financial Inclusion, **promoting financial education and literacy and making credit available to productive sectors of the economy including the rural and MSME sector.**

Constituents of The Indian Banking System

a) Public Sector banks

i. State Bank of India
ii. Nationalised Banks
iii. Other Public Sector Banks: IDBI Bank, Bhartiya Mahila Bank

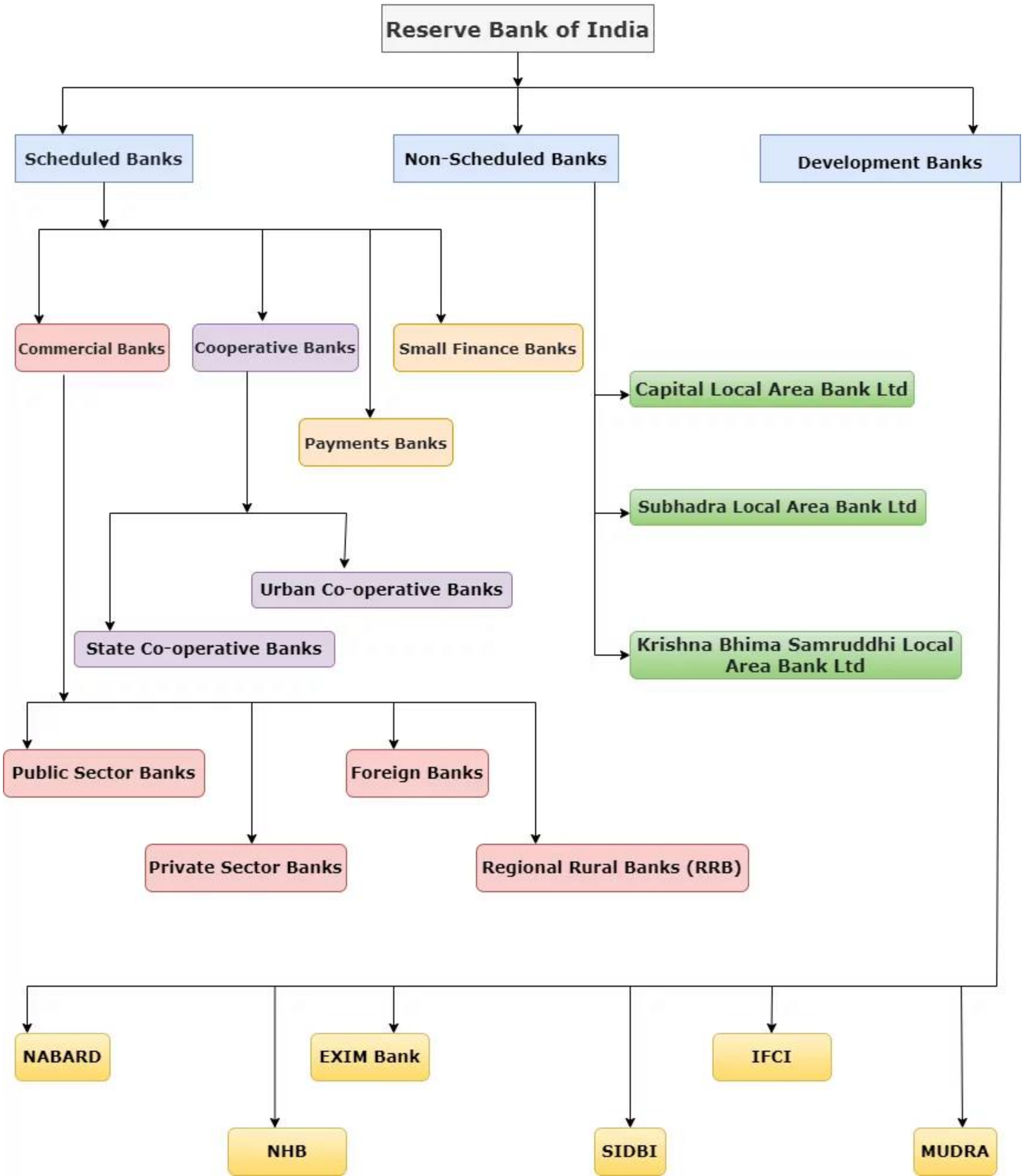
b) Private Sector Banks:

i. Old Private Sector Banks
ii. New Private Sector Banks
iii. Foreign Banks
iv. Payment Banks
v. Small Finance Banks
vi. Local Area Banks

c) Regional Rural Banks

d) State Co-operative Banks and District Central Co-operative Banks

e) Urban Co-operative Banks


Reserve Bank of India
Scheduled Banks
Non-Scheduled Banks
Development Banks
Commercial Banks
Cooperative Banks
Small Finance Banks
Payments Banks
Capital Local Area Bank Ltd
Subhadra Local Area Bank Ltd
Urban Co-operative Banks
State Co-operative Banks
Krishna Bhima Samruddhi Local Area Bank Ltd
Public Sector Banks
Foreign Banks
Private Sector Banks
Regional Rural Banks (RRB)
NABARD
EXIM Bank
IFCI
NHB
SIDBI
MUDRA

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The Banking Regulation Act, 1949 provides a framework using which, **commercial banking in India is supervised and regulated.**

- **In the year 1965, the Act was amended to include cooperative banks** under its purview by adding the Section 56.
- **Small Finance Banks and Payment Banks are the types of banks added** to the system in the recent period.
- The objective of the setting up of small finance banks is to further financial inclusion by

i. **provision of savings vehicles** and
ii. **supply of credit to small business units, small and marginal farmers**, micro and small industries, and other unorganized sector entities, through high technology-low-cost operations.

- The objective of setting up of payment banks is to further financial including by providing

i. small savings accounts and
ii. **payment/remittance services** to migrant labour workforce, low-income households, small businesses, other unorganized sector entities and other users.

⇒Non-Banking Finance Companies (NBFCs)

- The non-banking financial institutions are the organizations that **facilitate bank-related financial services but does not have banking licenses.**

- NBFCs are allowed to raise deposits from the public and lend through various instruments including leasing, hire purchase and bill discounting etc.
- These **are licensed and supervised by the Central Banking Authority.** The Central Bank has prescribed that no NBFC can operate without obtaining a valid license from it.

⇒Primary Dealers (PDs)

- Primary dealers which are popularly known as PDs, **deal in government securities and deal in both the primary and secondary markets.**
- Their basic responsibility is to **provide markets for government securities and strengthen the government securities market.** Thus, the PDs are acting as a market maker for government securities.

⇒Financial Institutions (FIs)

- FIs focuses on **dealing with financial transactions, such as investments, loans and deposits.**
- FIs are development financial institutions which provide long-term funds for industry and agriculture.
- All these institutions are under the regulatory control of RBI and they are supervised by it through on-site inspections and off-site surveillance mechanism. The FIs **raise their resources through long-term bonds from the financial market and borrowings from international financial institutions**.

EQUITY AND DEBT MARKET

- Financial markets are the marketplace where various financial assets are traded. Equity and debt markets are two types of financial markets.
- As the name suggests, **the equity market is a market for equity-related securities, and the debt market is for debt-related securities**.

⇒Stock Exchanges

- It is a secure place where trading is done in a systematic way. Here, the securities are bought and sold as per well-structured rules and regulations. Securities includes debenture and share issued by a **public company that is correctly listed at the stock exchange, debenture and bonds issued by the government bodies, municipal and public bodies.**

⇒ Brokers

- Only brokers **approved by the capital market regulator can operate** on the stock exchange.
- Brokers **perform the job of intermediating between buyers and sellers of the securities**. They help build-up an order book, carry out price discovery and are responsible for honouring the brokers' contracts. The services are subject to brokerage.

⇒Equity and Debt Raisers

Companies wishing to raise equity or debt through stock exchanges have to approach a capital market regulator with the prescribed applications and a proforma prospectus for permission to raise equity and debt and to get them listed on a stock exchange.

⇒Investment Bankers (Merchant Bankers)

- Merchant banks undertake a number of activities such as **undertaking the issue of stocks, fund raising and management**.
- They also provide **advisory services and counsel on mergers and acquisitions etc.** They are licensed by the capital market regulators.

⇒Foreign Institutional Investors (FIIs)

- FII is an investor or investment fund that is **from or registered in a country outside of the one in which it is currently investing**.
- FIIs are foreign-based funds authorized by the Capital Market Regulator to invest in the Indian equity and debt market through stock exchanges.

⇒ Depositories

- Depositories hold securities in dematerialized (Demat) form (as opposed to physical form), **maintaining accounts of depository participants who, in turn, maintain sub- accounts of their customers.**

- On instructions of the stock exchange **clearing house, supported by documentation, a depository transfers securities from the buyers to sellers, whose accounts are maintained in electronic form.**

⇒ Mutual Funds

- A mutual fund is **a form of Collective Investment that pools money from investors and invests in Stocks, Debt and other Securities.**
- It is **a less risky investment option for an individual investor**. Mutual funds require the regulators' approval to start an asset management company (the fund) and each scheme has to be approved by the regulator before it is launched.

⇒ Registrars

- Registrars maintain a register of share and debenture holders and process share and debenture allocation, when issues are subscribed.
- Registrars too need regulator's approval to do business.

INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY OF INDIA (IRDAI)

- The Insurance Regulatory and Development Authority of India or the IRDAI is the **apex body responsible for regulating and developing the insurance industry in India.**

- It is an autonomous body. It was established by an act of **Parliament known as the Insurance Regulatory and Development Authority Act, 1999**. Hence, it is a statutory body.

- It is an agency of Government of India for supervision and development of companies in the insurance sector. It's a regulator for insurance business, both general and life assurance.

- It regulates **all aspects of insurance business, including licensing of insurance companies, framing regulations, approving products, about the conduct of business and supervising all insurance activities** in the country etc.

- IRDA Mission is 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**

THE MULTI COMMODITY EXCHANGE OF INDIA LIMITED (MCX)

- The Multi Commodity Exchange of India Limited (MCX), India's first listed exchange, is a state-of-the-art, commodity futures exchange that **facilitates online trading, and clearing and settlement of commodity futures transactions, thereby providing a platform for risk management**.

- The Exchange, which started operations in November 2003, operates within the regulatory framework of the Forward Contracts (Regulation) Act, 1952.

- MCX offers trading in varied commodity futures contracts across **segments including bullion, ferrous and non-ferrous metals, energy, and agricultural commodities**.

- The Exchange focuses on **providing commodity value to participants with neutral, secure and transparent trade mechanisms, and formulating quality parameters and trade regulations, in conformity with the regulatory framework**

DEVELOPMENT BANKS

- There are **more than 60 Development Banking Institutions** at both Central and State level.
- Focus on the working of major four development banks, which assist in extending long term lending and refinance facilities to different areas of the economy for the economic development pertaining to Small Scale and Medium industries, Agricultural Sector and Housing Sector.
- These financial institutions play crucial role in **assisting different segments including the rural economic development.**

⇒ *National Bank for Agriculture and Rural Development (NABARD)*

- In the year 1982, CRAFICARD or the Committee to Review Arrangements of Institutional Credit for Agriculture and Rural Development recommended the establishment of a developmental bank and accordingly, NABARD was set up.

- It was formed by a special parliamentary act. The chief focus of the organisation was the **advancement of rural India by enhancing the flow of credit for the upliftment of agriculture as well as the rural non-agricultural sector.**

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

Functions of NABARD

- 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 majors units:
    - Financial
    - Developmental
    - Supervision

- The financial support necessary to **build rural infrastructure** is provided by NABARD.

- Preparation of **district-level credit plans by NABARD are used to guide and motivate the banking industry** to achieve required targets.

- NABARD also **supervises the Regional Rural Banks (RRBs) and Cooperative Banks along with developing their banking practices** and integrating them to the Core Banking Solution (**CBS**) platform.

- NABARD also **helps handicraft artisans sell their products by training and providing a marketing platform** for them.

- NABARD has partnered with various leading global organisations and institutions affiliated with the World Bank that have played a role in transforming agriculture.

- It offers advisory services and financial assistance provided by these international partners to help in consultation with rural development and other agricultural practices.

⇒ *Small Industries Development Bank of India (SIDBI)*

- Small Industries Development Bank of India (SIDBI) is an independent financial institution aimed at **aiding the growth and development of Micro, Small and Medium Enterprises (MSMEs) which contribute significantly to the national economy in terms of production, employment and exports.**
- SIDBI was established with the mission of facilitating and strengthening the **flow of credit to Micro, Small and Medium Enterprises** and for addressing the developmental and financial gaps in the ecosystem of MSMEs.
- It is a statutory body set up **under an act of the Indian Parliament in 1990.**

Functions of SIDBI

- It aims at emerging as a single-window to meet the developmental and financial needs of MSMEs in order to make them globally competitive, strong, vibrant and to protect the institution as a customer-friendly financial body.
- It also aims at enhancing the wealth of shareholders through the modern technology platform.
- It is involved in the promotion and development of the MSME sector.
- It is the principal institution for the development, promotion and financing of the MSME sector and for coordination of functions of the institutions engaged in similar activities.
- SIDBI retained its position in the top 30 Development Banks of the World in the ranking of The Banker, London.
- SIDBI also functions as a Nodal/Implementing Agency to various ministries of the Government of India viz., Ministry of MSME, Ministry of Textiles, Ministry of Commerce and Industry, Ministry of Food Processing and Industry, etc.

Financial Support of SIDBI to MSMEs

1) Indirect financing by way of refinancing the banks, refinancing financial institutions for onward lending to MSMEs.
2) Direct financing by way of service sector financing, receivable financing, risk capital and sustainable financing, etc.

⇒ *National Housing Bank (NHB)*

- National Housing Bank was set up in July, 1988 as the apex financing institution, for the housing sector, with the mandate **to promote efficient, viable and sound Housing Finance Companies (HFCs).**

- It facilitates augmenting the flow of institutional credit for the housing sector and regulate the HFCs. NHB mobilises resources and channelizes them to various schemes of housing infrastructure development.

- It provides refinance for direct housing loans given by commercial banks and non-banking financial institutions. The NHB also provides **refinance to Housing Finance Institutions for direct lending for construction/purchase of new housing/ dwelling units, public agencies for land development and shelter projects, primary cooperative housing societies, property developers**. At present, it is a wholly owned subsidiary of Reserve Bank of India which contributed the entire paid-up capital.

- RBI has proposed to transfer its entire shareholding to Government of India to avoid conflict of ownership and regulatory role. For this **transfer, the central bank will pay RBI, in cash, an amount equal to the face value of the subscribed capital issued by the RBI.**

⇒ *Export-Import Barks of India (EXIM Bank)*

- EXIM Bank or Export-Import Bank of India is India's leading export financing institute that engages in integrating foreign trade and investment with the country's economic growth.

- Founded in 1982 by the Government of India, EXIM Bank is a wholly-owned subsidiary of the Indian Government.

- Exim Bank lays special emphasis on extension **of Lines of Credit (LOCs) to overseas entities, national governments, regional financial institutions and commercial banks.**

- Exim Bank also **extends Buyer's credit and Supplier's credit to finance and promote country's exports**.