Indian
Financial System

ABHIJIT DUTTA
Dean (Academics) & Professor (Finance)
Mahendra Institute of Management and Technical Studies, Bhubaneswar

EXCEL BOOKS

Brief Contents

Foreword		*xiii*
Preface		*xv*
Acknowledgements		*xvii*
About the Author		*xix*
Legend of Abbreviations		*xxi*
	PART I: INTRODUCTION TO INDIAN FINANCIAL SYSTEM	
Chapter 1	Introduction to Indian Financial System	3
Chapter 2	Saving Intermediation and Financial Market	11
	PART II: FINANCIAL MARKETS IN INDIA	
Chapter 3	Organization of Financial Market in India	17
Chapter 4	Primary Market in India	21
Chapter 5	Secondary Market and Stock Market Organization	91
Chapter 6	Instruments in Secondary Market and Issuance Methods	159
Chapter 7	SEBI and Regulation of Capital Market	169
Chapter 8	Listing Regulations	185
Chapter 9	Money Market	211
Chapter 10	Foreign Exchange Market	247
Chapter 11	Merchant Banking	257
	PART III: BANKS IN INDIA	
Chapter 12	Introduction to Banking	301
Chapter 13	Commercial Banks in India	321
Chapter 14	Management of Financial Risk in Commercial Banks	343
Chapter 15	Effect of Basel II on the Indian Banking Sector	361
Chapter 16	Central Banks and the Reserve Bank of India	387
	PART IV: OTHER FINANCIAL INSTITUTIONS	
Chapter 17	Co-operative Credit Societies	415
Chapter 18	Regional Rural Banks	421
Chapter 19	Non-banking Financial Companies	425

Chapter 20 Mutual Funds 435

Chapter 21 Insurance Sector 453

Chapter 22 Microfinance and Microinsurance 467

References 485

Index 487

Detailed Contents

Foreword xiii
Preface xv
Acknowledgements xvii
About the Author xix
Legend of Abbreviations xxi

PART I: INTRODUCTION TO INDIAN FINANCIAL SYSTEM

Chapter 1: Introduction to Indian Financial System 3
- Introduction 4
- Characteristics of a Good Financial System 5
- Major Financial Intermediaries in Indian Financial System 6
- Interlinkage of the Financial Markets 7
- The Indian Government Fiscal System 9
- Summary 9
- Questions 10

Chapter 2: Saving Intermediation and Financial Market 11
- Introduction 12
- Saving and Capital Formation 12
- Functions of the Financial System 12
- Phases in Development of Indian Financial System 13
- Summary 14
- Questions 14

PART II: FINANCIAL MARKETS IN INDIA

Chapter 3: Organization of Financial Market in India 17
- Introduction 18
- The Industrial Securities Market 18
- The Money Market 19
- The Foreign Exchange Market 19
- Summary 19
- Questions 19

Chapter 4: Primary Market in India 21
- Introduction 22
- Organization of the Primary Market 22
- Primary Market Activities/Procedures 33
- Summary 88
- Questions 89
- Annexure 4.1 90

Chapter 5: Secondary Market and Stock Market Organization 91
- Introduction 92
- Stock Broking 92
- Custodial Services 109
- Depository System 113
- Short-selling and Securities Lending and Borrowing Scheme, 2008 132
- Summary 139
- Questions 139
- Annexure 5.1 141
- Appendix 5.1 148
- Appendix 5.2 152

Chapter 6: Instruments in Secondary Market and Issuance Methods 159
- Introduction 160
- Types of Capital 160
- Issue of Securities 164
- Summary 168
- Questions 168

Chapter 7: SEBI and Regulation of Capital Market 169
- Introduction 170
- Historical Perspective 170
- Philosophy of Regulations 171
- Securities and Exchange Board of India (SEBI) 171
- Major Steps Initiated by SEBI 174
- Self-regulation of the Markets 179
- International Organization of Securities Commissions (IOSCO) 181
- Summary 183
- Questions 184

Chapter 8: Listing Regulations 185
- Introduction 186
- Delisting of Securities Guidelines 2003 186
- Listing Agreement 194
- Corporate Governance as stated in Clause 49 195
- Summary 204
- Questions 205
- Annexure 8.1 206

- Annexure 8.2 208
- Annexure 8.3 210

Chapter 9: Money Market 211

- Introduction 212
- The Need for a Money Market 212
- Money Market Players 212
- Money Market Instruments and Features 214
- Risk Exposure in Money Market Instruments 220
- Integration in the Money Market 223
- Overseas Money Markets 223
- Monetary Policy 229
- Interest Rate Structure in the Indian Money Market 241
- Interlinkages in the Markets 243
- Summary 244
- Questions 245

Chapter 10: Foreign Exchange Market 247

- Introduction 248
- Foreign Exchange Market 248
- Rate of Exchange 249
- Exchange Control 251
- RBI and the Foreign Exchange Control 252
- Exchange Arithmetic 254
- Summary 255
- Questions 255

Chapter 11: Merchant Banking 257

- Introduction 258
- Merchant Banking in India 258
- Organization of Merchant Banking Units 260
- Investment Banking vs. Merchant Banking 261
- Nature of Merchant Banking 262
- Activities of Merchant Bankers (July 1, 1998) 263
- International Code and Standards 271
- SEBI Guidelines 273
- Net Offer to Public 290
- Salient Features of Offer Documents 292
- Guidelines for OTCEI Issues 296
- Summary 297
- Questions 297

PART III: BANKS IN INDIA

Chapter 12: Introduction to Banking 301

- Introduction 302
- Commercial Banking 302
- Various Types of Banks in India 304
- History of Banking in India 305
- Summary 309
- Questions 310
- Annexure 12.1 311
- References 319

Chapter 13: Commercial Banks in India 321

- Introduction 322
- Growth of Commercial Banks in India 322
- Prudential Norms relating to Credit/Advances and Investment Portfolios of Banks 324
- Management of Non-performing Assets 328
- Issues in Managing Balance Sheet of Commercial Bank 332
- Summary 333
- Questions 334
- Annexure 13.1 335

Chapter 14: Management of Financial Risk in Commercial Banks 343

- Introduction 344
- Types of Risks in Banks 344
- Credit Process 345
- Salient Points for Appraisal, Sanction, Post-sanction Control and Follow-up of Advances 357
- Summary 360
- Questions 360

Chapter 15: Effect of Basel II on the Indian Banking Sector 361

- Introduction 362
- Recent Developments 362
- Basel II Rationale and Objectives 364
- Key Changes – The Original Basel Accord versus Basel II 365
- Features of Indian Financial System 371
- Approach to Prudential Norms: A Review 371
- Implementation of Basel II in India 372
- Key Issues for Banks in India 375
- Implementation of Basel-II in India – RBI Approach 377
- Challenges for Indian Banking System under Basel II 378
- Steps for Implementing Risk Management 380
- Implementation of Basel II in Advanced Countries and Consequent Impact on Emerging Economies 383
- Summary 386
- Questions 386

Chapter 16: Central Banks and the Reserve Bank of India 387
- Introduction 388
- Central Bank and its Functions 388
- History of the Reserve Bank of India 391
- Constitution of the Reserve Bank of India (RBI) 391
- Functions of the RBI 392
- Instruments of Credit Control 395
- Reserve Bank of India and Agricultural Credit 401
- Financial Assistance by Reserve Bank 403
- The Reserve Bank of India and Bill Market Scheme 407
- Summary 409
- Questions 410

PART IV: OTHER FINANCIAL INSTITUTIONS

Chapter 17: Co-operative Credit Societies 415
- Introduction 416
- Organization of Credit Co-operative Institutions 416
- National Bank for Agriculture and Rural Development (NABARD) 417
- Reforms in Co-operative Credit 418
- Summary 418
- Questions 419

Chapter 18: Regional Rural Banks 421
- Introduction 422
- RBI and Assistance to RRBs 422
- Performance Evaluation of RRBs 422
- Regulatory Control of RRBs 423
- Rural Credit Delivery System of RRBs 423
- Role of RRBs in Poverty Alleviation 423
- Summary 424
- Questions 424

Chapter 19: Non-banking Financial Companies 425
- Introduction 426
- Current Scenario of the NBFCs Business 428
- Regulation of NBFCs 428
- Major NBFCs in India 429
- Venture Capital Funds (VCFs) 432
- Liberalization of Non-banking Financial Companies 433
- Summary 434
- Questions 434

Chapter 20: Mutual Funds 435
- Introduction 436
- Issuance and Organization of Mutual Funds 437
- Advantages and Disadvantages of Investing in Mutual Funds 438
- Banks vs. Mutual Funds 440
- Origin and Growth of Mutual Funds and Major Players in India 442
- Major Mutual Fund Companies in India 444
- Types of Mutual Fund 445
- Summary 447
- Questions 447
- References 447
- Glossary of Terms used in the Mutual Fund Industry 448

Chapter 21: Insurance Sector 453
- Introduction 454
- Liberalization of Non-life Insurance 455
- Regulatory and Micro-economic Challenges in Insurance in India 459
- Impact of Macro-economic Changes in Perception of Insurance 464
- Summary 465
- Questions 466

Chapter 22: Microfinance and Microinsurance 467
- Introduction 468
- Principles and Premises of Microfinance 469
- Debates on the Issues and Premises 470
- Financial Needs and Financial Services 472
- Current Scale of Microfinance Operations 474
- Inclusive Financial Systems 475
- Microcredit and the Web 477
- Evidence for Reducing Poverty 477
- Microfinance and Social Interventions 478
- Other Criticisms 478
- Microfinance in India 479
- Microinsurance 480
- Microinsurance Products 482
- Microinsurance Delivery Models 482
- Microinsurance Scheme 483
- Microinsurance and Development 483
- Summary 484
- Questions 484

References 485

Index 487

CHAPTER ONE

INTRODUCTION TO INDIAN FINANCIAL SYSTEM

LEARNING OBJECTIVES

- Financial System and its Organization
- The Components of Financial Markets

Introduction

The economic growth of a nation is dependent on the way the saving that is generated in the economy is transferred to the investment, which gets converted to fruitful production process. This in turn, generates gross output in the economy. This becomes an important point in the measurement of the growth of the national economy.

This above method is known as the capital formation where, it goes through three distinct stages, i.e., Saving, Finance and Investment. Funds flow from the surplus saving to the deficit areas of the economy (we will discuss this issue later in the next chapter of the book).

In order to enable capital formation, there is a requirement of intermediation or a system, which will create and channelize saving, leading to capital formation. The system, which does this function in the economy, is called the financial system.

Any financial system of the world comprises of three intermediaries. They are:

1. *Financial Intermediaries:* These are institutions which act as the link between the saver (giver of Fund) and Investor (user of fund) through institutional intervention. Most common amongst them are banks, insurance organizations, mutual funds and non-banking financial companies. All these institutions receive deposit and give loan. The way they receive deposit and the way they provide loan vary, depending upon the nature of their business. For example, a bank may have typical saving and current account to receive deposit and give short- and long-term loans to individuals and business houses. On the other had, an Insurance company may receive deposit as premium on policies and take part in the capital market or debt market to help the business receive money and form capital.

2. *Financial Markets:* These are places where the borrowers of fund and the lenders or givers of fund meet in various ways, depending on the demand and supply of fund. The financial market consists of the primary market or the market where the first-time lenders and the first-time borrowers meet; the secondary market, where, the persons who are interested in further investment come to buy and sell financial instruments (tools that are used to raise money by business); and the money market where lending and borrowing of money are done for shorter period of time and which is predominantly covered up by the government treasury activity.

3. *Regulators:* These are institutions either created by the government or by the bodies of the businesses themselves. These organizations help in delivery of the business in a legal manner and reduce the chances of fraud and misappropriation in financial market. In India, Securities Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA) and The Reserve Bank of India (RBI) are examples of regulators in capital and insurance market, respectively.

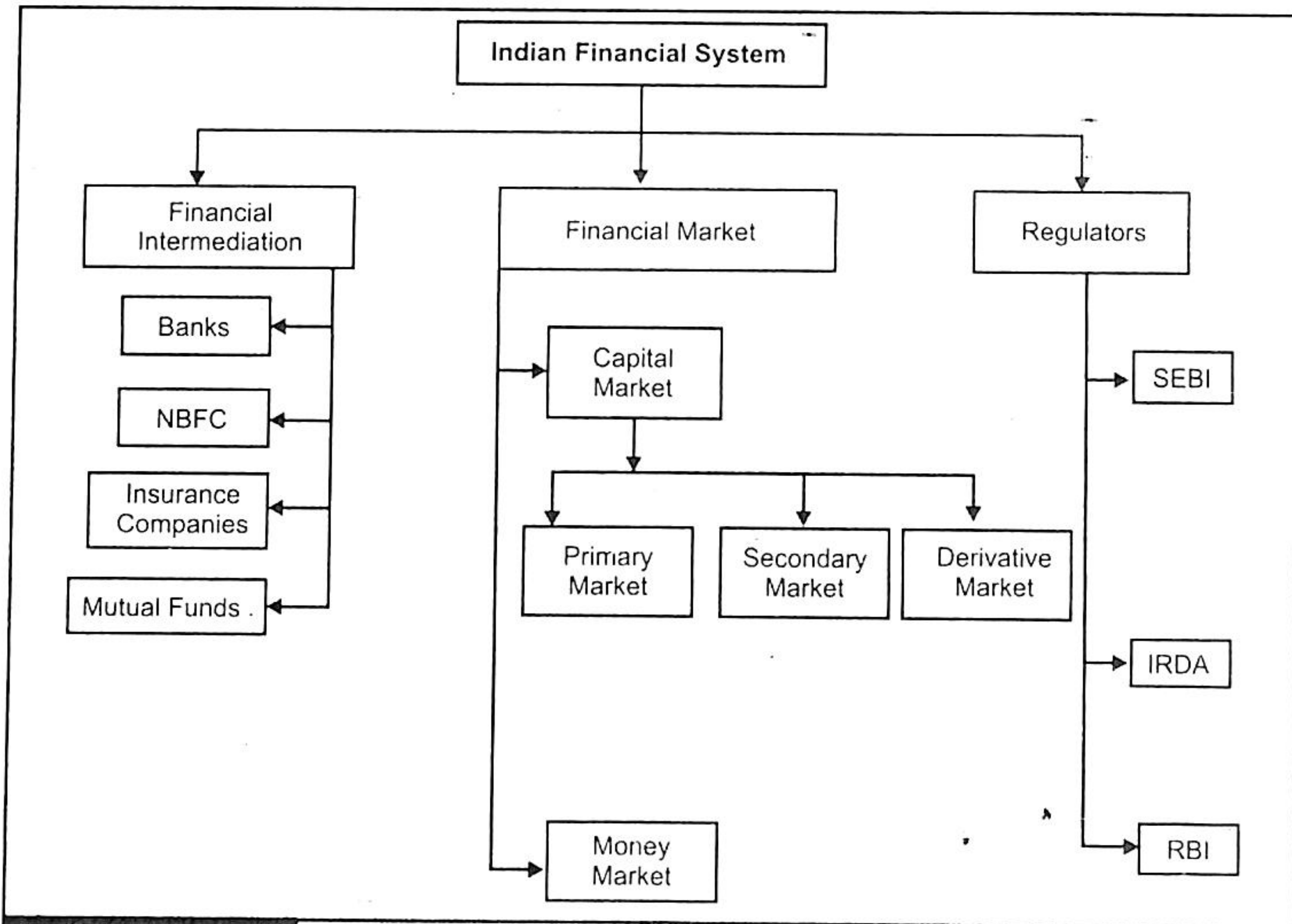

FIGURE 1.1
Organization of the Financial System in India

Characteristics of a Good Financial System

A financial system provides support to the suppliers of fund in the economy. It is quite obvious that, the providers of fund will seek certain basic services from the financial system, more so from the financial market and the financial intermediaries.

The services which suppliers of fund in the economy will seek from the financial system are:

1. *Low Risk:* The financial intermediation should ensure low risk for the supply of the funds in the economy. We all know that human beings are risk-averse and would prefer to work for lower risk, even if that means lower returns. However, if the financial intermediation provides only for low risk opportunities for the use of the fund, there will be very few takers of their services after some time, as the return will reduce. Hence, they should diversify the risk in as many financial instruments as possible, so that the fund providers have a balanced growth of their saving at the end of the process.

2. *Convenience:* Financial intermediation should provide convenience for mobilizing saving to be converted into investment. Convenience, in this regard, means that the avenues to save should be such, that they are affordable (in small units), should involve less paperwork and should be very transparent in terms of legal contract. It should provide the maturity (payback) in the convenience of the person, who does the saving.

3. *Efficient Management:* Financial intermediation should provide for an efficient management of funds which come to them. Efficient management means they should have expert investment system which understands the risk and return of the market, takes the decision in favour of the person who saves and ensures proper return of the money being used. The efficient system should also ensure that the intermediation makes best use of the fund available to them. One way to do that is to see that the economy of scale is achieved. Since they operate with a huge amount of money, they generally have the advantage of making the financial market move along their requirement optimally due to their size.

Major Financial Intermediaries in Indian Financial System

The major financial intermediaries are elaborated below.

1. *Commercial Banks:* These are institutions which receive money from individuals in form of deposit and lend the individual and business houses with loan for the requirement of short-term and long-term business requirement, especially, for the purpose of working capital. Banks create assets by giving loan and manage these assets by having liability products, such as saving bank account, current account and fixed deposits. Generally, the banks borrow at a lower rate and lend at a higher rate. They make a profit out of the difference of the rate of interest. This is known as fund-based banking. However, today, the new-generation banks also carry out a large number of activities for which they charge fees and make a substantial earning. Indian banking saw a major move by the Government of India in 1969, when major commercial banks were nationalized. This made the commercial banks the vehicle of development in the country. The commercial banks in India, therefore, act as an instrument of carrying out the major funding activities of the government for socio-economic development of the country.

2. *Non-Banking Financial Companies:* The non-banking financial companies or NBFCs are either fund based or advisory business in the financial system which, like banks, take deposit and lend money as loan, but in special ways. Some of the common NBFCs are Housing Finance Company (HF), Equipment Leasing Company (EL), Loan Company (LC), Mutual Benefit Companies or Nidhis, and Credit Rating Agencies.

3. *Mutual Funds:* These are organizations which take money in small amount and invest it in the financial market. The investors buy small units as investment and can sell these units back to unlock their investment. A mutual fund is set up as a trust, which

has a sponsor, a trustee, an Asset Management Company (AMC) and a custodian. Mutual funds are monitored by SEBI and through a self regulatory organization called Association of Mutual Fund India (AMFI).

4. *Insurance Companies:* Insurance is the business which covers the risk of the investors that includes life risk or business or other perils of life. For covering the risk, the insurance companies take funds from the individual who are covered for the risk (called the policyholder) as premium and invest in the market. In the eventuality of the risk arising on the policyholder, the agreed upon amount for covering the risk is paid to the policyholder. Insurance is a business in utmost good faith; hence, while the insurance is taken, the declaration of the policyholder is taken as true. However, when the payment is made, the risk is assessed by the company.

5. *Financial Market:* These are intermediations where the general public or the business organization come together to get their fund requirement fulfilled. These may be primary market, where the givers and takers of fund meet for the first time and the secondary market, where the investment procured in the primary market are bought and sold. The financial markets are of two kinds, capital market and the money market. The capital market helps in raising the long term funds for business and the money market helps in raising short term finance for the business.

6. *Regulators:* These are agencies which regulate the financial intermediation so that the chances of financial fraud are reduced. They act as protection for the market participants, such as investors and help in the proper growth of the market. SEBI, IRDA and RBI acts as regulator in the Indian financial system in various ways.

Interlinkage of the Financial Markets

The intermediaries in the financial market are interlinked and help in the flow of funds in the system. Some of the commonalties are:

Credit

One of the prime unifying factors of the various financial markets is credit. Since all markets provide credit, borrowers and lenders can switch from one market to another seeking the most favorable credit terms. Such shifting of borrowings from one market to another may take place to reduce the credit costs.

Speculation

Yet another common feature present in these markets relate to speculation. Investors in securities will get returns in the form of interest or capital gains in the long-term. Speculators in securities are always on the look out for speculative gains that can arise either due to certain market sensitive information or through their forecasts on certain future market developments. Such forecasts may be about interest rate movements, security prices, government policies, etc.

Arbitrage

Arbitrage is the other unifying factor of the financial markets. Arbitrageurs take advantage of the price differentials existing in the markets. When the prices of securities in one market appear to be out of line with the other market, arbitrageurs switch over to that market offering the best of prices. Thus, arbitraging enables transfer of funds from one market to another.

However, for a financial market to globalize its operations, its level of efficiency has to meet the world standards. For the foreign companies and investors to operate, there should be a level playing field for foreign and domestic investors. Open access to membership on all exchanges and suitable technology that ensures transparency in transactions, efficient payment and settlement system, easy flow of information are some of the features which help globalization of markets.

Irrespective of being a national or a global market, the suppliers of funds in these markets will essentially look for adequate returns, high safety and high levels of liquidity while lending their funds. Thus, the borrowers of funds will have to design suitable financial instruments that meet the requirements of the lenders. It is based on these features that the financial assets are grouped and the transactions takes place in the financial markets.

Financial Assets

Financial assets/instruments represent the financial obligations that arise when the borrower raises funds in the financial market. In exchange for the funds lent, the supplier will have a claim on the income/wealth of the borrower which may be a corporate, a government body or a household. This financial claim will be packaged in the form of a certificate, receipt or any other legal document.

Financial assets play a key role in developing the financial markets, in particular and the financial system, in general. Their importance to the system can be understood while distinguishing these assets from the real assets. All assets are financed by liabilities as the accounting concept advocates. While the assets can be either financial or real assets, the liabilities will be either in the form of savings or financial liabilities. Financial assets represent the obligations on the part of the issuer of such financial asset. Hence, all financial assets will be equal to the financial liabilities. The funding of assets will be done either by using savings or by borrowing. Since borrowings represent financial liabilities, the accounting equation can be altered as follows:

$$\text{Assets} = \text{Liabilities}$$

Since financial assets are equal to financial liabilities, the real assets will be financed by savings. This relationship has the following implicit assumptions:

1. There are no external borrowings in the system.
2. Financial liabilities include stock issued to the outsiders.

From the above equation, it can be understood that the surplus funds of an economic unit will either be used by the saver to purchase a real asset or will be lent to other economic units to buy real assets. Thus, all real asset purchases within the system will be made from the savings in the system.

An important aspect that is to be noted here is the process through which the savings are transformed into real assets, since it has an important bearing on the economic progress. This can be explained by the fact that savings can be transformed into real assets for consumption purpose or they can also be transformed into real assets through the investment channel. These two excess of savings for consumption purpose will be detrimental for the economic progress, since it will result in scarcity of funds for investment. While both demand and supply are necessary for economic growth, the deployment of savings should be such that it ensures equilibrium.

It, thus, implies that stimulating savings into financial assets for ultimate purchase of real assets promotes the role of the financial markets in the system.

The Indian Government Fiscal System

Any discussion on Indian financial system would not be complete unless one discusses, at least in brief, the Indian government fiscal system. The Indian fiscal system is divided between the State Governments and Union Government (called the Central Government). The Union Government exercises control on the financial market through various wings which include SEBI, RBI and other such sectoral regulatory authorities. That apart, the Union Government sets up Finance Commission every five years in order to decide the sharing of income tax and Union excise duties, grant-in-aids (as given in Article 275(1) of the Constitution of India) of the state revenues and other matters referred to it.

The Union Government does the financial administration primarily through the Annual Budget allocation (known as the Financial Bill/Act). The budget presents the transaction for four years including the estimate of the forthcoming year. The estimates are shown on revenue and capital accounts.

The State Governments also administer their fiscal process through an annual budget as defined by the State List in the Constitution of India.

Summary

This chapter introduces the concept of the financial system and helps in understanding the organization of the Indian financial system. The Indian financial system has, broadly, three parts, the financial institutions, the financial markets and the regulators. The financial system has some common linkages which are manifested by the credit, arbitrage, speculation and assets. The Indian government's fiscal system is divided between the states and the Union Government which regulate the fiscal process, through the various regulating bodies

and the finance commission. A yearly budget is created to monitor and supervise the fund and fiscal process of the state.

Questions

1. What is a financial system? What are the requirements of a financial system in an economy?
2. Give a detailed description of the organizations of the Indian financial system. Explain the components of the Indian financial system.
3. What are the roles which the regulators play in the financial markets?
4. Explain how all the financial markets have something in common.