ISSN: 2321-7782 (Online)
e-ISJN: A4372-3114
Impact Factor: 6.047
Volume 5, Issue 2, February 2017
International Journal of Advance Research in Computer Science and Management Studies
Research Article / Survey Paper / Case Study
Available online at: www.ijarcsms.com

Financial System in India: A Theoretical Aspect

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Abstract: During the last decade, the Indian economy has shown a great transformation from a closed, controlled, slow growing economy to a more open, more liberalised and also one of the fast growing economy among the developing nations. A financial system functions as an intermediary and facilitates the flow of funds among various other units of the system. It helps to mobilize and pool savings, promote payment services, produce and process information. In order to make financial system more effective and efficient, the need of effective management and control among the different components of the Financial System is required. Also there is a need for proper governance and regulation for the efficient working of the financial system.

Keywords: India, Financial System, Financial Institutions, Capital Market, Financial Instruments.

I. INTRODUCTION

Money plays an important role in daily life and in every activity of man- individuals, businesses and the government. Money is necessary for production & distribution and also for the country's developmental activities and the proper management of money are called Finance. Thus, Finance is the 'life blood of every human activity'. According to Webster's New Dictionary finance is "the managing or the science of managing money matters", and financing is "to supply or obtain money or credit". Hence, finance refers to funds or monetary resources needed by individuals, business houses and the government (Gomez, 2013).

But money and finance alone cannot lead to economic development. Here, financial system plays an important role for economic growth and development of the nation. A financial system functions as an intermediary and facilitates the flow of funds amongst the various units of the system. The financial system of any country includes its financial markets and supporting financial institutions. The word 'system' in the term "financial system" includes a set of complex and closely interrelated financial institutions, agents, practices, markets, transactions, claims, assets and liabilities in the economy helping to facilitate the movement of funds in order to enhance economic development.

The financial system helps to mobilize and pool savings, promote payment services, produce and process information about investors and investment projects, to enable efficient allocation of funds, monitor investments and help to diversify, transform and manage risk (Demirguc-kunt, 2006). The Indian economy is one of the fastest growing economies among the developing countries in the world. It is possible due to the connected or interlined financial system in India. The Indian financial system consists of financial institutions (like banks etc.), financial markets (like money and capital market etc.), financial instruments (like bills, shares, debentures etc.) and financial services (like merchant banking etc.).

II. Objective of the Study

This research study revolves on the axis of four objectives which are carefully outlined hereunder:

i) To study the Indian Financial System and its functions.

ii) To study the various constituents of Indian Financial System.

iii) To study the weaknesses of Indian Financial System.

III. Research Methodology

The study concentrates basically on the Financial System in India and the components involved in it. For this purpose the contents related to the study are taken from the articles and books written by the different research scholars and eminent authors.

IV. Review of Literature

Levine (1997) she defines the effectiveness of financial system in economic growth and also gives a functional approach which helps to understand the relation between growth and the quality of the functions provided by the financial system.

Hanson and Kathuria (1999) in their study discussed the importance of legal, regulatory and supervisory issues in reform and provide a brief history of India's shifts from financial repression to financial liberalization. They have also pointed out some interrelated challenges that India faces after these financial sector reforms.

Arora and Leach (2005) provide a study of financial service market of South Africa and point out some lessons from them for the Indian Service Market. Although there are so many differences between the two economies, such as geographical, population size, per capita income, political and economical etc. the banking sector of the south Africa shows a rapid increase in the last decade with a vision to reduce the access exclusion, condition exclusion, price exclusion, marketing exclusion and self-exclusion.

Allen, Chakrabarti and De (2007) in their study pointed out that in recent years India remains a developing country with all its sheen and dazzling capital market performance, but still the financial system excludes about 40% of the population, mostly the rural poor. They also highlighted the efficiency and efficacy of financial sector, privatization progress and major changes of banking sector, valuable norms of corporate governance and the importance of microfinance as a profitable method of poverty alleviation and development in India.

Khatua and Pradhan (2014) presented an understanding of overreaction effects, which would enable investors to prepare trading strategies for higher returns and shows strong overreaction and reversal effect. The trading strategy could be used to make contrarian profit from the overreaction and reversal effects. The study also concluded that overreaction is more prominent in the case of unspecified events rather than specified events.

Sen and kar (2014) in their study examine the political and institutional causes of India's growth acceleration and separated the post-reform growth experience into three distinct growth episodes. They suggested the re-emergence of credible and repeated personalised relationships between economic and political elites that are neither exclusionary nor politically illegitimate is essential for economic growth in India.

Narasimhan and Kalra (2014) examined the impact of derivative trading on liquidity in the Indian Stock Market. The study used the price-impact based liquidity measure. The results of the study showed a shift in the volume from cash market to derivatives market, decline in the number of trades, increase in liquidity of stocks during the short-run and lower volatility after the introduction of derivative trading. It was also concluded that the impact of derivative trading on long-term liquidity of the market depends on the level of liquidity prior to the introduction of derivative trading.

V. Indian Financial System: An Introduction

During the last decade, the Indian economy has shown a great transformation from a closed, controlled, slow economy growing to a more open, more liberalised and also one of the fast growing economy among the developing nations. Since economic reforms in 1991, Indian economy has accelerated growth, developed primary market, new financial instruments and a well functioning and developing secondary market for the economic development of the country. The saving rates in India are continually rising. The structural change in Indian economy enhance the involvement of genuine investors, Foreign Institutional Investors (FII), Foreign Direct Investment (FDI) and Financial Intermediaries such as Public Financial Institutions, Non-Banking Financial Companies (NBFCs), Commercial Banks, housing Banks etc.

VI. Function of a Financial System

The financial system of a country performs various valuable functions for the economic growth and development of the country. The main functions of a financial system are discussed as follows:

i) Function of collection and distribution of savings: A financial system performs a vital role in capital formation. It serves a link between saver and investor to mobilise savings and channelize them into productive activities for the transformation of savings into investments.

ii) Function of Liquidity: The important function of a financial system is to provide the money or near money assets for the production of goods and services. Near money assets are those assets which can be easily converted into cash.

iii) Payment and Settlement function: Payment and settlement system ensure the safely and timely movements of funds. Generally banks perform this type of functions in a financial system.

iv) Risk Management function: An efficient financial system reduces the risk involved in mobilising savings and allocating credit for the efficient transformation of savings into investment. It encourages the investors for optimum utilisation of funds.

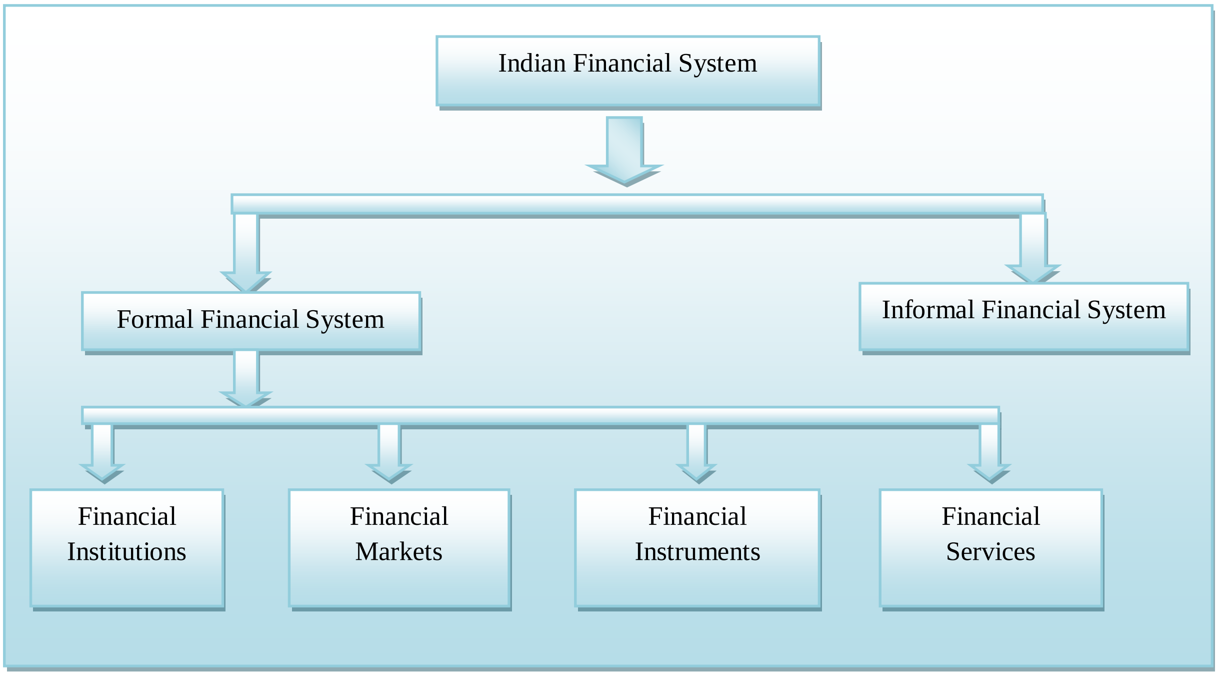
v) Information Availability functions: An efficient financial system provides necessary information to the operators or players of the market such as individuals, investors, business houses etc.

vi) Cost Reduction function: The financial system helps in creation of a financial structure that lowers the cost of borrowings and cost of transactions.

viii) Other Functions: The financial system also performs some other functions. Such as: promote the process of capital formation, introducing innovative financial instruments, provide necessary services related to finance, offers portfolio adjustment facilities etc.

VII. Constituents of Indian Financial System

A financial System of any economy consists of financial institutions, financial intermediaries, financial market, financial instruments etc. The Indian financial system consists of financial institutions, financial markets, financial instruments and financial services. As shown in Graph-1.



The Indian Financial system can be broadly classified into two systems: one is Formal (Organized) financial system and other is Informal (Unorganized) financial system.

A) Formal Financial System: This is also known as organized financial system because it comes under the preview of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI) and other regulatory bodies. Formal financial system consists of four sub-systems. These are: (i) Financial Institutions (ii) Financial Markets (iii) Financial Instruments and (iv) Financial Services.

I) FINANCIAL INSTITUTIONS

Finance is the prerequisite for the economic development of any country and financial institutions play a vital role in India for meeting such requirements. Financial institutions act as a facilitator of credits and deposits of the investors and various stakeholders. These are also known as intermediaries because the duties performed by the financial institutions are just like a mediator which helps in collection of deposits and distributes credit to the parties. There are two categories of Financial Institutions i.e., banking institution and non-banking financial institutions (Tiwari, 2012).

i) Banking Institutions: Banking institutions take deposits from the depositors and then distribute the interest on these deposits. They also provide credit facilities to the individuals and institutions (Tiwari, 2012). The banking industry in India is under the control of the Central Bank i.e. Reserve Bank of India. RBI organises, supervises, regulates and develops the monetary system & financial system of the country. The rapid economic growth and development leads the rapid expansion of commercial banks in India. The nationalisation of banks and the introduction of Lead Bank Schemes provide a momentum to the branch expansion. At present (as per table 1.1), the national average of population per bank office has reduced from 64000 (1969) to 12,600 (2013).

Table 1.1 Branch Expansions of All Commercial Banks

Year	Total no. of Branches	Rural Branches	Percentage of Rural Branches	Population per bank office
1969	8,260	1,860	22%	63,800
1991	60,220	35,206	58.5%	14,150
2011	90,620	33,800	37.3%	13,300
2012	97,111	35,850	36.9%	12,660
2013	98,607	36,452	37%	12,670

Source: Economic Survey 2009-10, RBI Trends and Progress of Banking n India 2009-10, Handbook of Statistics on the Indian Economy 2011-12, Statistical Table Relating to Banks in India, 2012-13.

The commercial banks in India cover 36,452 villages out of the 6 lakh villages of the county. The Indian banking institutions can be classified into two categories: Organised and Unorganised sector. The organised banking sector consists of commercial banks, cooperative bank, regional rural banks (RRBs) and foreign banks etc. The unorganised sector includes the indigenous bankers, grocery shops, chit fund, landlords, money lenders etc. in India (Gupta, 2012).

ii) Non-Banking Financial Institutions: Non-banking financial institutions consist of development financial institutions which provide loan to the industries for development and growth. They are responsible for the collection of deposits and invest in some other forms to get returns and then distribute to the unit holders. NBFIs include LIC, IIBI, SIDBI, IFCI (All India Financial Institutions), SFCs, SIDCs etc.

II) FINANCIAL MARKETS

A Financial Market can be defined as the situation in which financial assets or financial instruments are created or transferred from one to another. Financial market performs some important functions for the efficient working of financial system. Financial markets can be broadly classified into two markets. One is negotiated loan market e.g. a market in which the lender and the borrower personally negotiate the terms of the loan agreement. The other one is open market where standardised securities are traded in large volume (Gupta, 2012). The followings are the classification of financial markets on the basis of different categories:

i) Classification on the basis of Nature of Claim:

a) Debt Market: A debt market is a market where debt instruments are traded. There are two methods to generate funds in a financial market. One is to issue equities and the other is to issue debt instrument. Nowadays, the debt instruments are more popular for fund raising. The debt instrument is a contractual agreement by the borrower to pay a fixed amount at regular basis till the maturity date. These are classified in three categories: i) short term, ii) medium term, iii) long term. If the maturity of the debt instrument is less than one year, it is a short term debt instrument. If its maturity is more than one year but less than ten years, then it is a medium term debt instrument. The debt instrument with a maturity more than ten years is said to be a long term debt instrument.

b) Equity Market: An equity market is a market where equities are bought and sold. The equity shares are also known as ordinary or common shares. The equity shareholders are the real owner of the company. They gets dividend for their investment. The rate of dividend varies with the profits of the company and the policies of the board of directors.

ii) Classification on the basis of Maturity of Claim:

a) Money Market: The money market can be defined as 'the place where the demand for and supply of short-term funds meet'. According to Crowther "the money market is the collective name given to the different firms and institutions that deal in the different grades of near money" (Gomez, 2013). Thus, money market is a reservoir of short term funds. It is a place where short term funds are bought and sold via telephone or mail. Funds are borrowed in the market for a short period ranging from one day to six month or more but less than one year. The assets which are used as credit instruments are well known as "Near Money Assets" (Gupta et.al, 2012). Money market includes other sub-markets such as Call Money Market, Collateral Loan Market, Acceptance Market and Bill Market.

b) Capital Market: The capital market is the place where the long-term debt or equities or capital market securities are traded. Capital market securities, such as stocks and long-term bonds are often traded in the market. In last few years, Indian capital market has been one of the best performing market in the world. Fuelled with strong economic growth and large inflow of foreign institutional investors (FIIs) and also the development of the domestic mutual funds industry, the Indian Stock Market Indices have delivered truly explosive during the last decade. Also, the two major Indian exchanges, the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) ranked 16th and 17th respectively among the stock exchanges around the world in terms of Market Capitalisation. The stock market is touching new heights year on year since 2003. The biggest development in the Indian Capital Markets is the introduction of Derivatives. The derivatives segment becomes a crucial part of Indian Capital Market nowadays (Allen et. al, 2007).

iii) Classification on the basis of Seasoning of Claim:

a) Primary Market: The new issue market represents the primary market where new financial instruments (such as shares, bonds) are first time offered. The companies whether new or existing raise their capital through new issue. Primary market directs the flow of long term funds from the willing investors to corporate enterprises. The new issue market involves intermediaries for the efficient issue of securities. The primary market cannot be completed without these specialised intermediaries. These specialised intermediaries are known as merchant bankers, underwriters, brokers, agents, debenture trustees, portfolio managers etc.

b) Secondary Market: Secondary market is a market where the previously issued securities are traded. A well functioning secondary market includes specialised security brokers and dealers. The investors desire liquidity for their investments as per their requirement. Here, they want to sell the securities which they hold. The brokers perform the role of agents of investors for the buying and selling of the securities. Thus, secondary market provides a place for the buying and selling of securities as well as fulfils the liquidity requirements of the investors.

c) Derivatives Market: The derivatives segment in India is not so old. The introduction of derivatives makes an incomplete market more complete and increase the investment opportunities for the traders to invest in the market. Derivatives also provide convenience when investors desire to hedge the risk or arbitrageur wants additional liquidity for the markets (Narasimhan and Kalra, 2014). In June 2000, NSE started its operations in derivatives contracts and introduced future contracts on the Nifty index. The recognition of single- stock futures distinguishes the Indian Derivatives Markets with other markets and due to this popularity, the NSE of India ranked first (1st) in the single stock future category with 68,911,754 contracts in the year 2005. Nowadays Derivatives contracts are permitted on both the BSE and NSE (Allen et. al, 2007).

III) FINANCIAL INSTRUMENTS:

The third important component of financial system is financial instruments or assets. They represent claims on income (asset) and are held for the sake of returns that are expected. Thus, financial instrument or assets represents a claim to the payment of a sum of money in future in the form of interest or dividend. Financial instruments are different from each other in respect of their investment features. They are classified in two categories: i) on the basis of term, ii) on the basis of type.

i) The classification on the basis of term:

a) Short term: If the maturity of the financial instrument is less than one year, it is a short term financial instrument. **b) Medium term:** If the maturity is more than one year but less than ten years, then it is a medium term financial instrument. **c) Long term:** If the maturity of financial instrument is more than ten years is said to be a long term financial instrument.

ii) The classification on the basis of type:

a) Primary Securities: The securities which are directly issued by the borrower to the ultimate investor, is known as direct securities or primary securities. It includes equity shares, preference shares, debentures etc.

b) Secondary Securities: These are also called Indirect Securities, because these are not directly traded by the borrower to the ultimate investor. These are issued by the financial intermediaries to thee investors.

c) New Innovative Financial Instruments: A new significant change is required for the new investment strategies related with domestic as well as foreign investors of the market. The new financial instrument has some new features in terms of agreements, maturity, risk, return, marketability and transaction costs etc. Some new innovative financial instruments are: American Depository Receipts, Global Depository Receipts, Zero Coupon Convertible note, Secured Premium Notes with detachable warrants, Fully Convertible Debentures, Floating Rate Bonds, Equity Warrants, Deep Discount Bonds etc.

IV) Financial Services: Efficiency of an emerging financial system essentially depends upon the quality and variety of financial services provided by financial intermediaries. Financial services refer to the services rendered by the finance industry. Here, finance industry includes a broad range of organisation that deal with the management of money. These organisations include banks, credit card companies, insurance companies, consumer finance companies and some government sponsored enterprises of the country.

B) INFORMAL FINANCIAL SYSTEM

This is also known as unorganized financial system because it does not come under the preview of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI) and other regulatory bodies. An informal financial system is an unorganised, non-institutional and non-regulated system which deals with the traditional and rural spheres of the economy.

VIII. WEAKNESS OF INDIAN FINANCIAL SYSTEM

Today Indian financial system is more developed and integrated as compared to what it was 67 years ago. However, there are certain weaknesses in this system. These are as follows:

i) Lack of co-ordination: Due to the large number of financial institutions, sometimes the problem of co-ordination among the financial institutions may persist. In Indian economy there are different financial institutions and their large number leads to difficulty in co-ordination.

ii) Lack of involvement of investors from semi-urban and rural areas: Investors from semi-urban and rural areas are less aware and more risk averse than the other investors in Indian capital market. Also the expenses for sending the application forms to these areas increase

iii) Institutional Monopoly: Some of the financial institutions enjoy monopolistic market structure. Some financial institutions are large; so they enjoy a monopoly market structure. This large structure leads to inefficiency in their working or such type of mismanagement.

iv) Dominance of financial institutions in capital market: The dominance of financial institutions leads the unhealthy financial practices among corporate customers. Say, when corporate enterprises face financial crisis, the financial institutions permit a large use of debt than is warranted. This will make the condition worse.

v) Difficult to run an over-regulated financial system: Indian financial system is a combination of various institutions, markets, service sectors etc. The banking system is also very large. Sometimes this makes irregularities in their work performance. Even sometimes there is lack of co-ordination among the various banks in money market.

IX. CONCLUSION

Economic growth and development of a nation depends upon the efficiency of a developed financial system. There are two different viewpoints regarding the relationship between financial development and economic growth. According to first view point, an efficient financial system effectively mobilises the financial resources and after that invest them in the best possible manner with the help of market mechanism which leads to economic development. According to other view point, economic development and financial development are complimentary to each other.

At present, the Indian financial sector has been able to expand its outreach to remote and distant areas through bank branches, ATMs, financial intermediaries and branchless banking solutions. In order to make financial system more effective and efficient, there is a need of effective management and control among the different components of the Indian Financial System. Also there is a need for proper governance and regulation for the efficient working of the financial system. At last, it can be concluded that a developed financial system leads the economic growth and development of the country. Hence, there is a positive and direct correlation between the growth in financial system and economic development.

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