MODULE 1

Financial System

When referring to the "financial system," the word "system" refers to a collection of complexly interconnected economic institutions, agents, practices, markets, transactions, claims, and liabilities. Money, credit, and finance are three ideas that are interconnected but yet slightly different from one another that are addressed by the financial system. The Indian financial system is composed of the financial market, financial instruments, and financial intermediation

The Indian financial system is a complex network of financial institutions, markets, instruments, and services that facilitate the flow of funds between savers and investors. It comprises various entities such as banks, non-banking financial companies (NBFCs), insurance companies, stock exchanges, mutual funds, pension funds, and other financial intermediaries.

The Indian Financial System plays a crucial role in mobilizing savings, allocating capital, and facilitating economic growth and development in the country.

Indian Financial System Functions

The Indian financial system has several functions that help to meet the financial needs of individuals and businesses. Here are some of the key functions of the Indian financial system:

- Mobilization of Savings: The Indian financial system helps to mobilize savings from various sectors of the economy and channel them towards productive investments. This is achieved through various financial intermediaries such as banks, mutual funds, and insurance companies.
- Allocation of Credit: The Indian financial system also plays a key role in allocating credit to different sectors of the economy. Banks and other financial institutions provide loans and credit facilities to businesses and individuals to help them meet their financial needs.
- Payment System: The financial system provides a safe and efficient payment mechanism to facilitate transactions between different individuals and businesses. This is achieved through various payment systems such as NEFT, RTGS, and IMPS.
- Risk Management: The financial system helps to manage risks associated with financial transactions. Financial intermediaries such as insurance companies provide risk management products such as life insurance, health insurance, and property insurance.

- Price Discovery: The Indian financial system also helps in the discovery of prices of financial assets such as stocks, bonds, and commodities. This is achieved through various financial intermediaries such as stock exchanges and commodity exchanges.
- Economic Development: The financial system plays a critical role in the economic development of the country. It provides financial resources for investment in infrastructure, industries, and other productive sectors of the economy.
- Financial Inclusion: The Indian financial system also strives to promote financial inclusion by providing access to financial services to individuals and businesses in remote and underdeveloped areas of the country.

Structure of the Indian Financial System and Markets

The term "financial structure" describes the structure, components, and order of the financial system. A formal (organized) financial system and an informal (unorganized) financial system can be used to broadly categorize the Indian financial system and Markets.

- **Informal Indian Financial System:** Individual lenders, groups of people acting as funds or associations, partnership firms made up of local brokers and pawnbrokers, as well as non-banking financial intermediaries like finance, investment, and chit-fund enterprises, make up the informal financial system.

- **Formal Indian Financial System:** Financial markets, financial instruments, financial services, and financial institutions make up the formal financial system.The Ministry of Finance, the RBI, the SEBI, and other regulating organizations make up the official Indian financial system. The Indian financial system is made up of the following elements, which will be briefly reviewed below

Financial Institutions

Banking Institutions:

Commercial Banks

Commercial banks are financial institutions that offer services such as accepting deposits, providing loans, and basic investment products.

These include Public Sector Banks (e.g., State Bank of India), Private Sector Banks (e.g., ICICI Bank), Regional Rural Banks (RRBs), and Foreign Banks (e.g., HSBC).

Cooperative Banks

Cooperative banks are owned and operated by their customers to provide banking services to members.

These are financial entities that operate on a cooperative basis, catering to the financial needs of the members.

Non-Banking Institutions

Organized Financial Institutions

Organized financial institutions are licensed entities that offer financial services and products, often regulated by government authorities.

Examples: It includes insurance companies and pension funds.

Unorganized Financial Institutions

Unorganized financial institutions operate informally, often without legal recognition, providing financial services within communities.

These are informal financial entities such as moneylenders and community savings groups.

Financial Markets

Money Market

The money market is a segment of the financial market in which financial instruments with high liquidity and short maturities are traded.

This includes the Call Money Market, Treasury Bills, and Commercial Bills.

Call Money Market

The call money market facilitates short-term borrowing and lending, often among banks, with transactions usually within a day.

It consists of the Primary Market, Secondary Market, and Derivative Market.

Financial Instruments

Based on Types

Primary Securities

Primary securities are financial instruments offered for the first time to investors, typically through an initial public offering (IPO) or bond issuance. These include stocks and bonds issued directly to investors.

Secondary Securities

Secondary securities are financial instruments that have already been issued and are traded among investors in the secondary market. Examples are stocks traded on stock exchanges.

Innovative Instruments

Innovative instruments include sophisticated financial products designed to cater to specific investment strategies and risk appetites. These involve complex financial products like derivatives and ETFs.

Based on Term

Short-Term Financial Instruments

- Easy to convert to cash within one year
- Highly liquid and flexible
- Offer lower returns than other types of investments

Examples: Treasury bills, Commercial bills, Call money market instruments

Medium-Term Financial Instruments

- Easy to convert to cash within one to five years
- Offer a balance of risk and return
- Good option for investors who are looking for moderate growth over a medium period

Examples: Some bonds, Some notes

Long-Term Financial Instruments

- Easy to convert to cash after five years or more
- Typically offer higher returns than other types of investments
- Also, involves higher risks

Examples: Stocks, Long-term bonds

Financial Services

Fund-Based Financial Services

Fund-based financial services involve providing capital to businesses for various purposes, often tied to specific assets or transactions.

Leasing, Hire Purchase, and Factoring: These services involve providing funds for asset acquisition and working capital needs.

Fee-Based Financial Services

Fee-based financial services generate revenue through fees charged for services like advisory, credit assessment, and facilitating mergers and acquisitions.

Merchant Banking, Credit Rating, and Mergers: These services charge fees for advisory, rating, and transactional services.

Banking :

Banking refers to the system of financial institutions, such as banks and credit unions, that provide various financial services to individuals, businesses, and governments. Banking services mainly include accepting deposits, lending money, facilitating transactions, and offering various financial products like savings accounts, loans, and credit cards.
Banking plays a crucial role in the economy by facilitating the flow of money and enabling economic activities.

Functions of Banks

Banks in India offer a wide range of banking services, such as savings and checking accounts, loans (personal, business, and mortgages), credit cards, investment services, and electronic banking options like online and mobile banking.

Some of the major functions of banks are mentioned below:

- Accepting Deposits: Banks provide a safe place for individuals and businesses to deposit their money, which can be withdrawn when needed.
- Providing Loans: Banks lend money to individuals and businesses for various purposes, such as home mortgages, business expansion, or personal loans.
- Payments and Settlements: Banks enable transactions through various payment methods, like checks, debit/credit cards, and electronic transfers.
- Currency Exchange: Many banks offer foreign exchange services, allowing customers to buy, sell, or exchange foreign currencies.
- Safekeeping of Valuables: Some banks offer safe deposit boxes for customers to securely store valuable items and documents.
- Investment Services: Banks also provide investment products like mutual funds, stocks, and bonds, helping customers grow their wealth.
- Internet Banking Services: Banks offer online and mobile banking services, making it convenient for customers to access their accounts, pay bills, and transfer funds.

Types of Banks in India
The Banking System in India is divided into several types, each serving specific functions and purposes. The table below represents the different types of banks in India and how it is further divided:

Banking Classification in India

Types of Banks	Sub-types
Central Bank	-
Commercial Banks	a) Private Sector Banks b) Public Sector Banks c) Regional Rural Banks d) Foreign Banks
Co-operative Banks	a) State Co-operative Banks b) Urban Co-operative Banks
Payment Banks	-
Small Finance Banks	-
Scheduled Banks	-
Non-scheduled Banks	-

1) Central Bank

The Reserve Bank of India (RBI) serves as the Central Bank of India and is responsible for regulating and controlling the monetary and banking system in the country.

2) Commercial Banks

These are the most common types of banks and include public sector banks, private sector banks, and foreign banks. They provide various services like savings and current accounts, loans, and investments.

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- Public Sector Banks: Owned and operated by the government, examples include State Bank of India (SBI), Punjab National Bank (PNB), and Bank of Baroda (BOB).

- Private Sector Banks: These are privately owned and managed banks, such as HDFC Bank, ICICI Bank, and Axis Bank.
- Foreign Banks: These banks have branches in India and are headquartered in foreign countries. Some examples are Citibank, Standard Chartered, and HSBC.
- Regional Rural Banks (RRBs): These banks cater to rural and semi-urban areas and are owned by the government, commercial banks, and state governments.

The table below shows a few examples of Commercial Banks in India.

Commercial Banks in India

Public Sector Banks	Private Sector Banks	Foreign Banks
Here is a list of public sector banks in India: • Bank of Maharashtra • Indian Bank • Bank of Baroda • Canara Bank • State Bank of India • Central Bank of India • Union Bank of India • Indian Overseas Bank • UCO Bank • Punjab & Sind Bank • Bank of India • Punjab National Bank	Here is the list of private sector banks in India: • I.C.I.C.I. Bank • R.B.L. Bank • I.D.F.C. Bank • South Indian Bank • IDBI Bank • Tamilnad Mercantile Bank • YES Bank • Axis Bank • City Union Bank • Karnataka Bank • Dhanlaxmi Bank • Kotak Mahindra Bank • D.C.B. Bank • Karur Vysya BanK	Here is a list of foreign banks that operate in India: • Australia and New Zealand Banking Group Ltd. • National Australia Bank • Westpac Banking Corporation • Bank of Bahrain & Kuwait BSC • AB Bank Ltd. • Credit Agricole Corporate & Investment Bank • Societe Generale • Deutsche Bank • HSBC Bank • PT Bank Maybank Indonesia TBK • Mizuho Bank Ltd.

3) Cooperative Banks

A Co-operative Bank is registered under the Co-operative Societies Act of 1912 and is run by an elected managing committee. It works on a non-profit, no-loss basis and mainly serves entrepreneurs, small businesses, self-employment, and more in urban areas.
In rural areas, it mainly functions to finance agriculture-based activities like farming, livestock, and hatcheries. There are mainly two types of Co-operative Banks:

Types of Cooperative Bank	Description
State Co-operative Banks	A State Co-operative Bank is a federation of the central Co-operative banks that will act as a custodian of the Co-operative banking structure in the State.
Urban Co-operative Banks	The Urban Co-operative Bank is the primary Co-operative bank located in urban and semi-urban areas. The banks essentially lent to smaller borrowers, and businesses centred around a community, locality, and more.

4) Payment Banks
The payment banks are a relatively new banking model in the country that has been conceptualised by the RBI. This bank is allowed to accept a restricted deposit. This amount is limited to Rs. 1 lakh for a customer. The bank also offers services such as ATM cards, net banking and more.
5) Small Finance Banks
These banks primarily serve the unserved and underserved sections of the population, including small businesses and low-income individuals.
This type of bank is licensed under Section 22 of the Banking Regulation Act 1949, and it is governed by the Provisions Act of 1934.
Here are a few examples of Small Finance Banks in India:

- AU Small Finance Bank Ltd.
- Utkarsh Small Finance Bank Ltd.
- Fincare Small Finance Bank Ltd.
- Ujjivan Small Finance Bank Ltd.
- Jana Small Finance Bank Ltd.
- Suryoday Small Finance Bank Ltd.
- Equitas Small Finance Bank Ltd.
- Capital Small Finance Bank Ltd.

- North East Small Finance Bank Ltd.

6) Scheduled Banks

These banks are covered under the 2nd Schedule of RBI Act 1934, and they need to have a paid-up capital of Rs. 5 lahks or more.

7) Non-Scheduled Banks

The non-scheduled banks are local area banks that are not listed in the 2nd Schedule of the RBI Act 1934.

Types of Bank Accounts in India

Given below are the common types of bank accounts in India:

- Savings Account: This is a basic account for individuals to save money. It offers interest on deposits and allows limited withdrawals.
- Current Account: This type of account is mainly used by businesses. It has zero or very low interest rates but offers more transaction features, making it suitable for frequent transactions.
- Fixed Deposit Account: In this account, you deposit a lump sum for a fixed tenure at a higher interest rate compared to savings accounts. Funds are locked in until maturity.
- Recurring Deposit Account: It is a savings plan where you deposit a fixed amount every month, and at the end of a specified period, you receive the principal and interest.
- NRI (Non-Resident Indian) Account: These are for Indians living abroad. NRE (Non-Resident External), NRO (Non-Resident Ordinary) and FCNR (Foreign Currency Non-Residential) accounts are major types of NRI accounts.
- Senior Citizen Savings Account: Created for senior citizens, these accounts offer higher interest rates and additional benefits.
- Salary Account: This account is used by an employer to credit the salary of an employee every month. It does not have any minimum balance requirement.
- Demat Account: This account is created primarily for holding and trading in securities electronically, such as stocks and bonds.
- Joint Account: It is shared by two or more individuals, often used for family or business purposes.
- Minor Account: Opened on behalf of minors by parents or guardians. The minor gains control upon reaching a certain age.
- Corporate Account: Used by companies and corporations for their banking needs, including payroll and transactions