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INDIAN FINANCIAL SYSTEM

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Indian Financial System

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Indian Financial System

Markets, Institutions and Services

Fifth Edition

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ISBN 978-93-528-6486-7
eISBN

First Impression

Published by Pearson India Education Services Pvt. Ltd, CIN: U72200TN2005PTC057128.

Head Office: 15th Floor, Tower-B, World Trade Tower, Plot No. 1, Block-C, Sector-16, Noida 201 301, Uttar Pradesh, India.
Registered Office: 4th Floor, Software Block, Elnet Software City, TS-140, Block 2 & 9, Rajiv Gandhi Salai, Taramani, Chennai 600 113, Tamil Nadu, India.
Fax: 080-30461003, Phone: 080-30461060
Website: in.pearson.com, Email: companysecretary.india@pearson.com

Compositor: D Book Media
Printed in India

In memory of my husband, the late Prof. V.A. Pathak, who continues to be my profound source of motivation.

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Preface

After undergoing the economic reforms initiated decades ago, the Indian financial system has now become a robust and complex ecosystem with a much greater degree of market interplay. After the first generation reforms of 1991, the financial system has metamorphosed into a substantive, self-regulating system and developed as one obeying no rules or dictates other than those consistent with its own character. It has left the backwaters and entered the open sea and though sometimes it was buffeted by swift, violent and complex happenings, it has shaped up into what a free financial system should be. It has chosen to be competitive, market-oriented, modern, cost-effective, has tried to remain afloat and struggled to push ahead, and has even build a surplus for hard times that may be in store. We may attribute this change to the winds of privatization and liberalization blowing all over the world. The transformation implies that the components of the Indian financial system, that is, the institutions and markets functioning within it have chosen to be well-managed and growth-oriented. It has become a modern, twenty-first century system having features such as derivatives market; new instruments such as deep discount bonds, securitized paper, floating rate bonds; bourses such as NSE, MCX-SX; new trading techniques such as computerized trading, Internet trading, direct access, margin trading, and rolling settlement; regulatory bodies such as the RBI, the SEBI and the IRDA; financial services such as credit rating, factoring, forfaiting and private banking; new entrants such as FIIs and QFIs in capital market; private insurance, micro insurance and so on.

While the first generation reforms have significantly succeeded in expanding the core financial markets like banking, mutual funds, insurance, stocks and commodities, there has been a sense of stagnation being felt over the last few years. On the other hand, penetration of financial services among the low-income segment that is a vast majority of Indian population which still remains abysmally low. The global financial crisis of 2008 did not significantly impact the Indian markets. Whether this was on account of the slightly conservative liberalization policies that could ensure sufficient checks and balances so as to insulate the system from global economic shocks or was it because the Indian markets could not be integrated sufficiently with the global ecosystem as a result of the half-hearted approach towards economic reforms. Or was it sheer luck? These are some of the questions that have been rigorously debated in India over the past few years. Amidst this debate the second generation reforms were initiated with a view to re-align the financial sector on its growth path. It has been more than two decades since the reform process in the Indian Financial System was initiated. What has been the overall impact of the reforms on the Indian economy is a matter of study.

Modernization of the system, its increased ability to function well and its vitality, along with the realization that books available on the subject are quite inadequate (some quite out of pace with sudden, complex changes) inspired and prompted me to write this book. The book is designed to serve both as a textbook as well as one for reference. I have tried my best to make it lucid in expression, sufficient in content and full of extracts and references with latest amendments and updates and I hope the reader will find it clear, sufficient and satisfactory. All recent amendments and changes upto June 2017 have been incorporated in the new edition.

The text encompasses new developments in the system and touches upon or discusses various components such as financial markets and institutions, instruments, agencies and regulations in an analytical and critical manner.

Section I of the book is an introduction to the term ‘financial system’. The key elements and functions of a financial system, financial systems design, financial markets and the links between different types of financial markets are explained. The second chapter puts the financial system in the context of the Indian economy by deploying a macro-economic framework analysis. The chapter also includes a literature review of studies in the Indian as well as international context in an attempt to explore the relationship between the financial system and economic growth. The section concludes with a historical perspective of the Indian financial system in the pre-reform era, objectives of financial sector reforms and the achievements till date.

Section II of the book gives an in-depth view of Indian financial markets. Separate chapters deal with different elements of financial markets like the money market, capital market, primary market, secondary market, derivative market and the debt market. New guidelines by the regulators relating to money market instruments-Commercial Paper, Certificate of Deposits, Repos and Tri-Repos, New Monetary Policy Framework and the New Base Rate Calculation have been discussed at length. In addition, disinvestment of public sector undertakings and the new financial instruments like floating rate bonds, zero coupon bonds, deep discount bonds, securitized paper, municipal bonds, etc., are also discussed. Introduction of new financial instruments such as Municipal bonds and Masala bonds and the auction of floating rate bonds have been discussed. New guidelines relating to capital financing by start-ups, delisting, external commercial borrowings, foreign portfolio investors, listing of securities have been covered.

Section III of the book delves into the institutional side of the financial system. An in-depth coverage of the concepts and institutional framework of various financial institutions like development finance institutions, banking and non-banking institutions, mutual funds and insurance sector have been provided for the benefit of the readers. A separate chapter has been dedicated to the management of non-performing assets by the banks. In case of banking, priority sector lending norms, new types of non-banking finance companies, and differentiated banking structure such as small finance banks and payments banks have also been discussed at length. The non-performing assets of the banks are a matter of concern for both the Reserve Bank of India and the Government. Various initiatives taken by the RBI and the Government to curb this menace have been included. The recently introduced Insolvency and Bankruptcy code 2016 (IBC) by the Government has been simplified for the students. New insurance concepts such as crop insurance, social insurance and mutual insurance, and new insurance intermediaries introduced in the insurance market have also been discussed.

Section IV shifts focus to financial services that support the core financial system components like investment banking, credit rating, factoring and forfaiting, housing finance and leasing and hire purchase. The guidelines relating to Housing Finance have been amended and a new concept—Mortgage Guarantee Companies have come into existence which is also included. The last chapter has been dedicated to the emerging issues of financial inclusion and micro-finance. The micro-finance industry has grown and initiatives taken by the government such as MUDRA, Pradhan Mantri Mudra Yojana and Micro-Finance Institutions Network set up as a Self-Regulatory Organisation have also been included.

The last section of the book also deals with financial regulation and the role of regulators like the RBI and SEBI.

What is New in This Edition?

- It has been twenty-five years since the reform process in the Indian financial system was initiated. The impact of these reforms on the Indian economy has been covered in Chapter 3 of this book.
- All recent amendments and changes upto June 2017 have been incorporated in the new edition. New guidelines by the regulators relating to money market instruments—Commercial Paper, Certificate of Deposits, Repos and Tri-Repos, New Monetary Policy Framework and New Base Rate Calculation has been discussed at length.
- Introduction of new financial instruments, such as, Municipal Bonds, Masala Bonds and auction of floating rate bonds have been discussed. New guidelines relating to capital financing by start-ups, de-listing, external commercial borrowings, foreign portfolio investors, and listing of securities have been covered.
- In case of banking, priority sector lending norms, new types of non-banking finance companies, and differentiated banking structure, such as, small finance banks and payment banks have been discussed at length.
- The non-performing assets of the banks are a matter of concern both for the Reserve Bank of India and the Government. Various initiatives taken by the RBI and the government to curb this menace have been included in Chapter 14 relating to management of NPAs by banks. The recently introduced Insolvency and Bankruptcy Code 2016 (IBC) by the government has been simplified for the students.
- New insurance concepts such as crop insurance, social insurance and mutual insurance, and new insurance intermediaries introduced in the insurance market have been discussed in Chapter 16.
- Guidelines relating to Housing Finance have been amended and new concept—Mortgage Guarantee Companies—have come into existence which are is included in Chapter 21.
- The micro-finance industry has grown and initiatives taken by the government such as MUDRA, Pradhan Mantri Mudra Yojana and Micro-finance Institutions Network set up as a Self-Regulatory Organisation have been included in Chapter 23.

Acknowledgements

The composition of the book has been a joint effort in the sense I have received abundant inspiration, encouragement and assistance from several gentlemen, the first of whom is my husband, late Prof V A Pathak, who stood by all along, bore many personal inconveniences, took sustained interest in the production of the book and offered whatever succour I needed. I am grateful to Arman Oza, an insurance consultant, for having shared his extensive experience of the insurance industry that made my task of writing the chapter on insurance quite easy. His expertise on microinsurance and risk management greatly helped me in writing on this subject. I extend my sincere thanks to Hiten M Parikh, Associate Professor at R J Tibrewal Commerce College, and Chartered Accountant, for providing me a case on financial restructuring. I am equally thankful to Mr Anish Kharidia, practicing Chartered Secretary and an eminent lawyer, for providing me valuable insights into the newly introduced Insolvency and Bankruptcy Code, 2016. And of course, my two Research Fellows in the School, Miss NC Raghavi Chakravarthy, Senior Research Fellow and Mr Dhaval Nakum, Junior Research Fellow who have helped me a lot in incorporating all the changes and amendments that have taken place. My sincere thanks to both of them.

I must also gratefully thankful to Prof B M Peerzada, a seasoned academician and professor of economics, who let me use the infrastructure of R J Tibrewal Commerce College and helped me identify the right publisher.

My parents, Harichand and Naina Gursahaney, my brother Pramod and my sisters Anita and Hema were highly supportive and provided me the much needed emotional support during times of stress which every writer undergoes. I have also been fortunate to have a

supporting daughter Jahnavi, who provided me the space without asking for it, so that I can relish the fruits of my academic enterprise. I have no words to describe the tolerance and composure displayed by Jahnavi while I was preoccupied in the composition of this book.

I am equally thankful to the editorial team of Pearson Education, for taking good care of the design and style of the book.

Most importantly, this book is now into its fifth edition. Over the past four editions and thirteen years, the Indian Financial System has undergone many changes and developments. It has been my pleasure in bringing out the updated editions of this book. The response from students, academics and readers, in general, has been heartening, to say the least. I would like to thank one and all for the tremendous response to this book, and also for the feedback and input which has inspired me to constantly update the contents of this book and make it richer with every edition.

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Part I

Financial System

1

The Financial System: An Introduction

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1. *Meaning of a financial system*
2. *Components of a financial system*
3. *Functions of a financial system*
4. *Key elements of a well-functioning financial system*
5. *Bank-based and market-based financial systems*
6. *Nature and role of financial institutions and financial markets*
7. *Link between money markets and capital markets*
8. *Link between primary markets and secondary markets*
9. *Functions and characteristics of financial markets*

INTRODUCTION

A financial system plays a vital role in the economic growth of a country. It intermediates between the flow of funds belonging to those who save a part of their income and those who invest in productive assets. It mobilizes and usefully allocates scarce resources of a country.

A financial system is a complex, well-integrated set of sub-systems of financial institutions, markets, instruments, and services which facilitates the transfer and allocation of funds, efficiently and effectively.

Formal and Informal Financial Sectors

The financial systems of most developing countries are characterized by coexistence and cooperation between the formal and informal financial sectors. This coexistence of these two sectors is commonly referred to as 'financial dualism.' The formal financial sector is characterized by the presence of an organized, institutional, and regulated system which caters to the financial needs of the modern spheres of economy; the informal financial sector is an unorganized, non-institutional, and non-regulated system dealing with the traditional and rural spheres of the economy.

The informal financial sector has emerged as a result of the intrinsic dualism of economic and social structures in developing countries, and financial repression which inhibits the certain deprived sections of society from accessing funds. The informal system is characterized by flexibility of operations and interface relationships between the creditor and the debtor. The advantages are: low transaction costs, minimal default risk, and transparency of procedures. Due to these advantages, a wide range and higher rates of interest prevail in the informal sector.

An interpenetration is found between the formal and informal systems in terms of operations, participants, and nature of activities which, in turn, have led to their coexistence. A high priority should be accorded to the development of an efficient formal financial system as it can offer lower intermediation costs and services to a wide base of savers and entrepreneurs.

Informal Financial System

Advantages
- Low transaction costs
- Minimum default risk
- Transparency of procedures

Disadvantages
- Wide range of interest rates
- Higher rates of interest
- Unregulated

The Indian Financial System

The Indian financial system can also be broadly classified into the formal (organized) financial system and the informal (unorganized) financial system. The formal financial system comes under the purview of the Ministry of Finance (MoF), the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), and other regulatory bodies. The informal financial system consists of:

- Individual moneylenders such as neighbours, relatives, landlords, traders, and storeowners.
- Groups of persons operating as 'funds' or 'associations.' These groups function under a system of their own rules and use names such as 'fixed fund,' 'association,' and 'saving club.'
- Partnership firms consisting of local brokers, pawnbrokers, and non-bank financial intermediaries such as finance, investment, and chit-fund companies.

In India, the spread of banking in rural areas has helped in enlarging the scope of the formal financial system.

COMPONENTS OF THE FORMAL FINANCIAL SYSTEM

The formal financial system consists of four segments or components. These are: financial institutions, financial markets, financial instruments, and financial services (refer Figure 1.1).

Financial Institutions

Classification of Financial Institutions

- Banking and non-banking
- Term finance
- Specialized
- Sectoral
- Investment
- State-level

These are intermediaries that mobilize savings and facilitate the allocation of funds in an efficient manner.

Financial institutions can be classified as banking and non-banking financial institutions. Banking institutions are creators and purveyors of credit while non-banking financial institutions are purveyors of credit. While the liabilities of banks are part of the money supply, this may not be true of non-banking financial institutions. In India, non-banking financial institutions, namely, the developmental financial institutions (DFIs), and non-banking financial companies (NBFCs) as well as housing finance companies (HFCs) are the major institutional purveyors of credit.

Financial institutions can also be classified as term-finance institutions such as the Industrial Development Bank of India (IDBI), the Industrial Credit and Investment Corporation of India (ICICI), the Industrial Financial Corporation of India (IFCI), the Small Industries Development Bank of India (SIDBI), and the Industrial Investment Bank of India (IIBI).

Financial institutions can be specialized finance institutions like the Export Import Bank of India (EXIM), the Tourism Finance Corporation of India (TFCI), ICICI Venture, the Infrastructure Development Finance Company (IDFC), and sectoral financial institutions such as the National Bank for Agricultural and Rural Development (NABARD) and the National Housing Bank (NHB).

Investment institutions in the business of mutual funds Unit Trust of India (UTI), public sector and private sector mutual funds and insurance activity of Life Insurance Corporation (LIC), General Insurance Corporation (GIC) and its subsidiaries are classified as financial institutions.

There are state-level financial institutions such as the State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs) which are owned and managed by the State governments.

In the post-reforms era, the role and nature of activity of these financial institutions have undergone a tremendous change. Banks have now undertaken non-bank activities and financial institutions have taken up banking functions. Most of the financial institutions now resort to financial markets for raising funds.

Financial Markets

Types

- Money market
- Capital market

Segments

- Primary market
- Secondary market

Financial markets are a mechanism enabling participants to deal in financial claims. The markets also provide a facility in which their demands and requirements interact to set a price for such claims.

The main organized financial markets in India are the money market and the capital market. The first is a market for short-term securities while the second is a market for long-term securities, *i.e.*, securities having a maturity period of one year or more.

Financial markets can also be classified as primary and secondary markets. While the primary market deals with new issues, the secondary market is meant for trading in outstanding or existing securities. There are two components of the secondary market: over-the-counter (OTC) market and the exchange traded market. The government securities market is an OTC market. In an OTC market, spot trades are negotiated and traded for immediate delivery and payment while in the exchange-traded market, trading takes place over a trading cycle in stock exchanges. Recently, the derivatives market (exchange traded) has come into existence.

Financial Instruments

A financial instrument is a claim against a person or an institution for payment, at a future date, of a sum of money and/or a periodic payment in the form of interest or dividend. The term 'and/or' implies that either of the payments will be sufficient but both of them may be promised. Financial instruments represent paper wealth shares, debentures, like bonds and notes. Many financial instruments are marketable as they are denominated in small amounts and traded in organized markets. This distinct feature of financial instruments has enabled people to hold a portfolio of different financial assets which, in turn, helps in reducing risk.

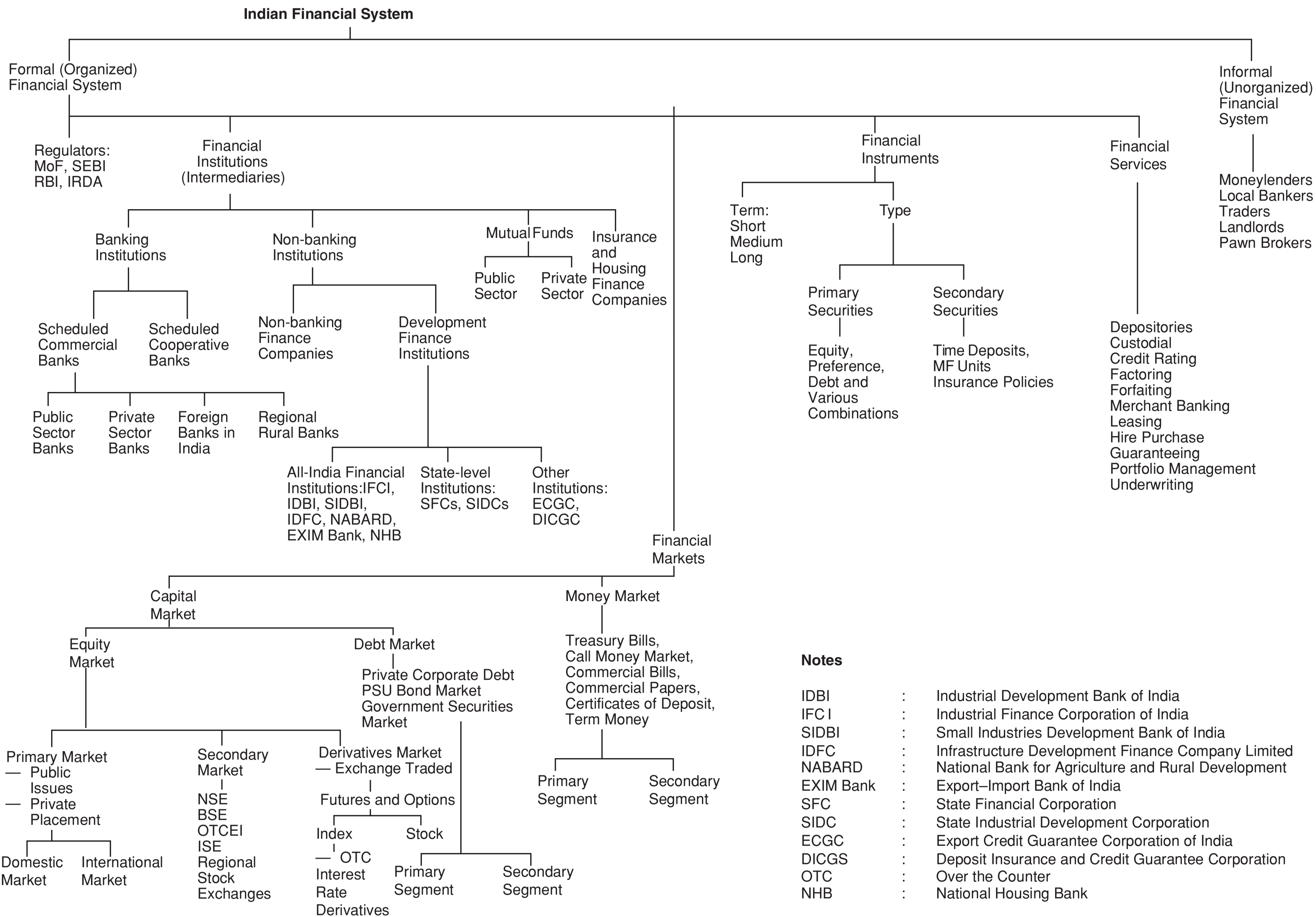


Figure 1.1 Indian Financial System

Types of Financial Securities

- Primary
- Secondary

Distinct Features

- Marketable
- Tradeable
- Tailor-made

Different types of financial instruments can be designed to suit the risk and return preferences of different classes of investors.

Savings and investments are linked through a wide variety of complex financial instruments known as 'securities.' Securities are defined in the Securities Contracts Regulation Act (SCRA), 1956 as including shares, scrips, stocks, bonds, debentures, debenture stocks or other marketable securities of a similar nature or of any incorporated company or body corporate, government securities, derivatives of securities, units of collective investment scheme, security receipts, interest and rights in securities, or any other instruments so declared by the central government.

Financial securities are financial instruments that are negotiable and tradeable. Financial securities may be primary or secondary securities. Primary securities are also termed as direct securities as they are directly issued by the ultimate borrowers of funds to the ultimate savers. Examples of primary or direct securities include equity shares and debentures. Secondary securities are also referred to as indirect securities, as they are issued by the financial intermediaries to the ultimate savers. Bank deposits, mutual fund units, and insurance policies are secondary securities.

Financial instruments differ in terms of marketability, liquidity, reversibility, type of options, return, risk, and transaction costs. Financial instruments help financial markets and financial intermediaries to perform the important role of channelizing funds from lenders to borrowers. Availability of different varieties of financial instruments helps financial intermediaries to improve their own risk management.

Financial Services

Need of Financial Services for

- Borrowing and funding
- Lending and investing
- Buying and selling securities
- Making and enabling
- Payments and settlements
- Managing risk

These are those that help with borrowing and funding, lending and investing, buying and selling securities, making and enabling payments and settlements, and managing risk exposures in financial markets. The major categories of financial services are funds intermediation, payments mechanism, provision of liquidity, risk management, and financial engineering.

Funds intermediating services link the saver and borrower which, in turn, leads to capital formation. New channels of financial intermediation have come into existence as a result of information technology. Payment services enable quick, safe, and convenient transfer of funds and settlement of transactions.

Liquidity is essential for the smooth functioning of a financial system. Financial liquidity of financial claims is enhanced through trading in securities. Liquidity is provided by brokers who act as dealers by assisting sellers and buyers and also by market makers who provide buy and sell quotes.

Financial services are necessary for the management of risk in the increasingly complex global economy. They enable risk transfer and protection from risk. Risk can be defined as a chance of loss. Risk transfer of services help the financial market participants to move unwanted risks to others who will accept it. The speculators who take on the risk need a trading platform to transfer this risk to other speculators. In addition, market participants need financial insurance to protect themselves from various types of risks such as interest rate fluctuations and exchange rate risk.

Growing competition and advances in communication and technology have forced firms to look for innovative ways for value creation. Financial engineering presents opportunities for value creation. These services refer to the process of designing, developing, and implementing innovative solutions for unique needs in funding, investing, and risk management. Restructuring of assets and/or liabilities, off balance sheet items, development of synthetic securities, and repackaging of financial claims are some examples of financial engineering.

The producers of these financial services are financial intermediaries, such as, banks, insurance companies, mutual funds, and stock exchanges. Financial intermediaries provide key financial services such as merchant banking, leasing, hire purchase, and credit-rating. Financial services rendered by the financial intermediaries bridge the gap between lack of knowledge on the part of investors and the increasing sophistication of financial instruments and markets. These financial services are vital for creation of firms, industrial expansion, and economic growth.

Before investors lend money, they need to be reassured that it is safe to exchange securities for funds. The financial regulator who regulates the conduct of the market and intermediaries to protect the investors' interests provides this reassurance. The regulator regulates the conduct of issuers of securities and the intermediaries to protect the interests of investors in securities and increases their confidence in markets which, in turn, helps in the growth and development of the financial system. Regulation is necessary not only to develop a system, but a system once developed needs to be regulated. The RBI regulates the money market and the SEBI regulates the capital market. The securities market is regulated

by the Department of Economic Affairs (DEA), the Department of Company Affairs (DCA), the RBI, and the SEBI. A high-level committee on capital and financial markets coordinates the activities of these agencies.

Interaction Among Financial System Components

Interaction Among the Components

- Interdependent
- Interactive
- Close links
- Competing with each other

The four financial system components discussed do not function in isolation. They are interdependent and interact continuously with each other. Their interaction leads to the development of a smoothly functioning financial system.

Financial institutions or intermediaries mobilize savings by issuing different types of financial instruments which are traded in the financial markets. To facilitate the credit-allocation process, these institutions acquire specialization and render specialized financial services.

Financial intermediaries have close links with the financial markets in the economy. Financial institutions acquire, hold, and trade financial securities which not only help in the credit-allocation process but also make the financial markets larger, more liquid, stable, and diversified. Financial intermediaries rely on financial markets to raise funds whenever the need arises. This increases the competition between financial markets and financial intermediaries for attracting investors and borrowers. The development of new sophisticated markets has led to the development of complex securities and portfolios. The evaluation of these complex securities, portfolios, and strategies requires financial expertise which financial intermediaries provide through financial services.

Financial markets have also made an impact on the functioning of financial intermediaries such as banks and financial institutions. The latter are, today, radically changed entities as the bulk of the service fees and non-interest income that they derive is directly or indirectly linked to financial market-related activities.

Moreover, liquid and broad markets make financial instruments a more attractive avenue for savings, and financial services may encourage further savings if the net returns to investors are raised or increased.

FUNCTIONS OF A FINANCIAL SYSTEM

Functions of a Financial System

- Mobilize and allocate savings
- Monitor corporate performance
- Provide payment and settlement systems
- Optimum allocation of risk-bearing and reduction
- Disseminate price-related information
- Offer portfolio adjustment facility
- Lower the cost of transactions
- Promote the process of financial deepening and broadening

One of the important functions of a financial system is to link the savers and investors and, thereby, help in mobilizing and allocating the savings efficiently and effectively. By acting as an efficient conduit for allocation of resources, it permits continuous upgradation of technologies for promoting growth on a sustained basis.

A financial system not only helps in selecting projects to be funded but also inspires the operators to monitor the performance of the investment. Financial markets and institutions help to monitor corporate performance and exert corporate control through the threat of hostile takeovers for underperforming firms.

It provides a payment mechanism for the exchange of goods and services and transfers economic resources through time and across geographic regions and industries. Payment and settlement systems play an important role to ensure that funds move safely, quickly, and in a timely manner. An efficient payment and settlement system contributes to the operating and allocation efficiencies of the financial system and thus, overall economic growth. Payment and settlement systems serve an important role in the economy as the main arteries of the financial sector. Banks provide this mechanism by offering a means of payment facility based upon cheques, promissory notes, credit and debit cards. This payment mechanism is now increasingly through electronic means. The clearing and settlements mechanism of the stock markets is done through depositories and clearing corporations.

One of the most important functions of a financial system is to achieve optimum allocation of risk bearing. It limits, pools, and trades the risks involved in mobilizing savings and allocating credit. An efficient financial system aims at containing risk within acceptable limits. It reduces risk by laying down rules governing the operation of the system. Risk reduction is achieved by holding diversified portfolios and screening of borrowers. Market participants gain protection from unexpected losses by buying financial insurance services. Risk is traded in the financial markets through financial instruments such as derivatives. Derivatives are risk shifting devices, they shift risk from those who have it but may not want it to those who are willing to take it.

A financial system also makes available price-related information which is a valuable assistance to those who need to take economic and financial decisions. Financial markets disseminate information for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment,

or holding a particular asset. This information dissemination enables a quick valuation of financial assets. Moreover, by influencing the market price of a firm's debt and equity instruments, this process of valuation guides the management as to whether their actions are consistent with the objective of shareholder wealth maximization. In addition, a financial system also minimises situations where the information is asymmetric and likely to affect motivations among operators when one party has the information and the other party does not. It also reduces the cost of gathering and analysing information to assist operators in taking decisions carefully.

A financial system also offers portfolio adjustment facilities. These are provided by financial markets and financial intermediaries such as banks and mutual funds. Portfolio adjustment facilities include services of providing a quick, cheap and reliable way of buying and selling a wide variety of financial assets.

A financial system helps in the creation of a financial structure that lowers the cost of transactions. This has a beneficial influence on the rate of return to savers. It also reduces the cost of borrowing. Thus, the system generates an impulse among the people to save more.

A well-functioning financial system helps in promoting the process of financial deepening and broadening. Financial deepening refers to an increase of financial assets as a percentage of the Gross Domestic Product (GDP). Financial depth is an important measure of financial system development as it measures the size of the financial intermediary sector. Depth equals the liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and non-bank financial intermediaries divided by the GDP). Financial broadening refers to building an increasing number and variety of participants and instruments.

KEY ELEMENTS OF A WELL-FUNCTIONING FINANCIAL SYSTEM

Basic Elements of a Well-functioning Financial System

- A strong legal and regulatory environment
- Stable money
- Sound public finances and public debt management
- A central bank
- Sound banking system
- Information system
- Well-functioning securities market

The basic elements of a well-functioning financial system are (i) a strong legal and regulatory environment, (ii) stable money, (iii) sound public finances and public debt management, (iv) a central bank, (v) a sound banking system, (vi) an information system, and (vii) a well-functioning securities market.

Since finance is based on contracts, strong legal and regulatory systems that produce and strictly enforce laws alone can protect the rights and interests of investors. Hence, a strong legal system is the most fundamental element of a sound financial system.

Stable money is an important constituent as it serves as a medium of exchange, a store of value (a reserve of future purchasing power), and a standard of value (unit of account) for all the goods and services we might wish to trade in. Large fluctuations and depreciation in the value of money lead to financial crises and impede the growth of the economy.

Sound public finance includes setting and controlling public expenditure priorities and raising revenues adequate to fund them efficiently. Historically, these financing needs of the governments world over led to the creation of financial systems. Developed countries have sound public finances and public debt management practices, which result in the development of a good financial system.

A central bank supervises and regulates the operations of the banking system. It acts as a banker to the banks, banker to the government, manager of public debt and foreign exchange, and lender of the last resort. The monetary policy of the central bank influences the pace of economic growth. An autonomous central bank paves the way for the development of a sound financial system.

A good financial system must also have a variety of banks both with domestic and international operations together with an ability to withstand adverse shocks without failing. Banks are the core financial intermediaries in all countries. They perform diverse key functions such as operating the clearing and payments system, and the foreign exchange market. The banking system is the main fulcrum for transmitting the monetary policy actions. Banks also undertake credit risk analysis, assessing the expected risk and return on the projects. The financial soundness of the banking system depends on how effectively banks perform these diverse functions.

Another foundational element is information. All the participants in a financial system require information. A sound financial system can develop only when proper disclosure practices and networking of information systems are adopted.

Securities markets facilitate the issue and trading of securities, both equity and debt. Efficient securities markets promote economic growth by mobilizing and deploying funds into productive uses, lowering the cost of capital for firms, enhancing liquidity, and attracting foreign investment. An efficient securities market strengthens market discipline by exerting corporate control through the threat of hostile takeovers for underperforming firms.

FINANCIAL SYSTEM DESIGNS

Financial System Designs

- Bank-based
- Market-based

A financial system is a vertical arrangement of a well-integrated chain of financial markets and institutions that provide financial intermediation. Different designs of financial systems are found in different countries. The structure of the economy, its pattern of evolution, and political, technical, and cultural differences affect the design (type) of financial system.

Two prominent polar designs can be identified among the variety that exists. At one extreme is the bank-dominated system, such as in Germany, where a few large banks play a dominant role and the stock market is not important. At the other extreme is the market-dominated financial system, as in the US, where financial markets play an important role while the banking industry is much less concentrated. The other major industrial countries fall in between these two extremes (Figure 1.2).

Demirguc Kunt and Levine (1999) have provided explanations of bank-based and market-based financial systems. In bank-based financial systems, banks play a pivotal role in mobilizing savings, allocating capital, overseeing the investment decisions of corporate managers, and providing risk-management facilities. In market-based financial systems, the securities markets share centre stage with banks in mobilizing the society's savings for firms, exerting corporate control, and easing risk management.

Bank-based systems tend to be stronger in countries where governments have a direct hand in industrial development. In India, banks have traditionally been the dominant entities of financial intermediation. The nationalization of banks, an administered interest rate regime, and the government policy of favouring banks led to the predominance of a bank-based financial system.

Demirguc Kunt and Levine, using a database of 150 countries, have classified countries according to the structure and level of financial development (Table 1.1).

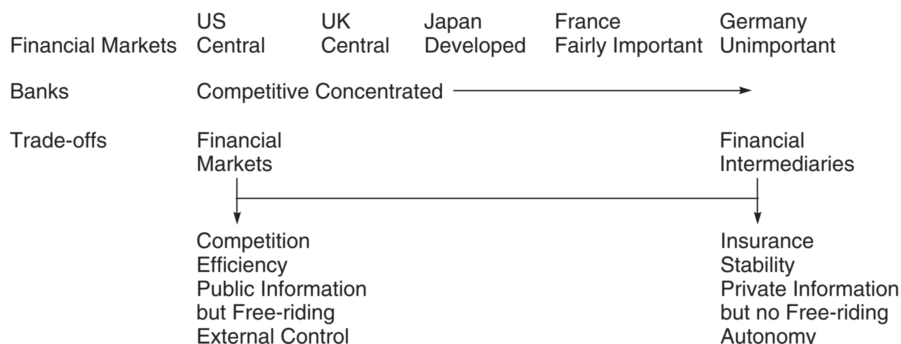
Their comparison of financial systems across different income groups reveals several patterns. First, financial systems are, on an average, more developed in rich countries. There is a tendency for a financial system to become more market-oriented as the country becomes richer. Second, countries with a common-law tradition, strong protection of shareholders' rights, and low levels of corruption tend to be more market-based and have well-developed financial systems.

Arnold and Walz (2000) have attempted to identify factors leading to the emergence of bank-based or market-based financial systems. When problems relating to information persist but banks are competent

TABLE 1.1 Classification of Financial Structure and Level of Development of Select Economies

Extent of Development	*Bank-based*	*Market-based*
Developed	Japan, Germany, France, Italy	US, UK, Singapore, Malaysia, Korea
Under-developed	Argentina, Pakistan, Sri Lanka, Bangladesh	Brazil, Mexico, the Philippines, Turkey

Source: Demirguc Kunt, A. and R. Levine (1999), Bank-based and Market-based Financial System: Cross-Country Comparisons, World Bank Policy Research Working Paper No. 2143.



Source: Allen and Gale (2000), *Comparing Financial Systems*, MIT Press, Cambridge, Mass.

Figure 1.2 Overview and Trade-offs of Financial Systems