An Introduction to Indian Financial System – Provisions of Important Acts in Relation to Regulation and Supervision

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An Introduction to Indian Financial System

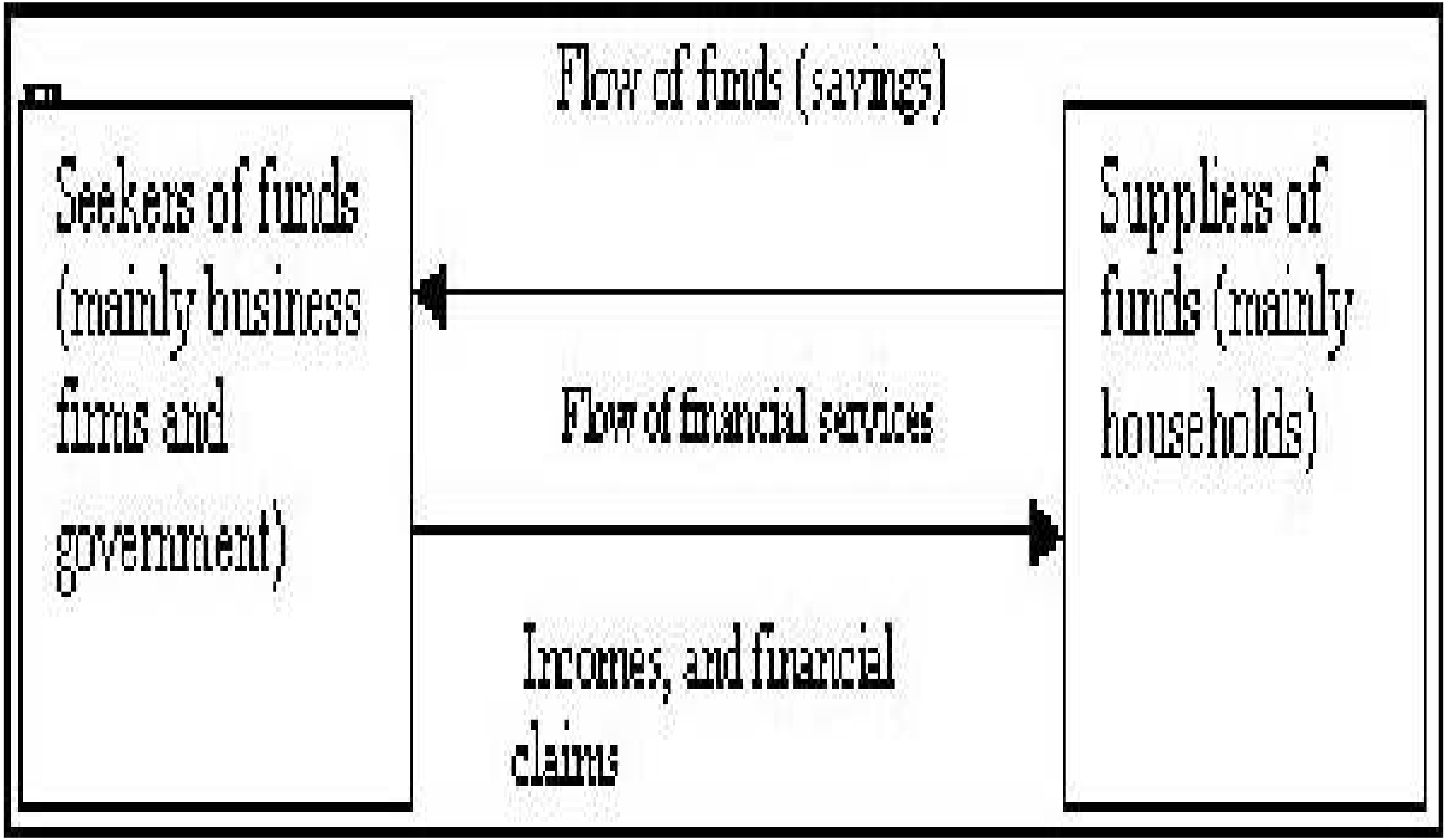
- The financial system plays an important role in promoting economic growth not only by channeling savings into investments but also by improving allocative efficiency of resources.
- The recent empirical evidence, in fact, suggests that financial system contributes to economic growth more by improving the allocative efficiency of resources than by channeling of resources from savers to investors.
- An efficient financial system is now regarded as a necessary pre-condition for growth.

An Introduction to Indian Financial System....

- This shift in the emphasis along with opening up of domestic economies to international competition has encouraged emerging market economies (EMEs) to introduce financial sector reforms.
- In the wake of the financial crises of the 1990s however, the role of the financial system in growth has been subjected to a critical reassessment.
- Increased financial integration has exposed the countries to the risk of contagion. It is now widely recognised that stability of the financial system is critical for a sustainable growth.

Financial System……

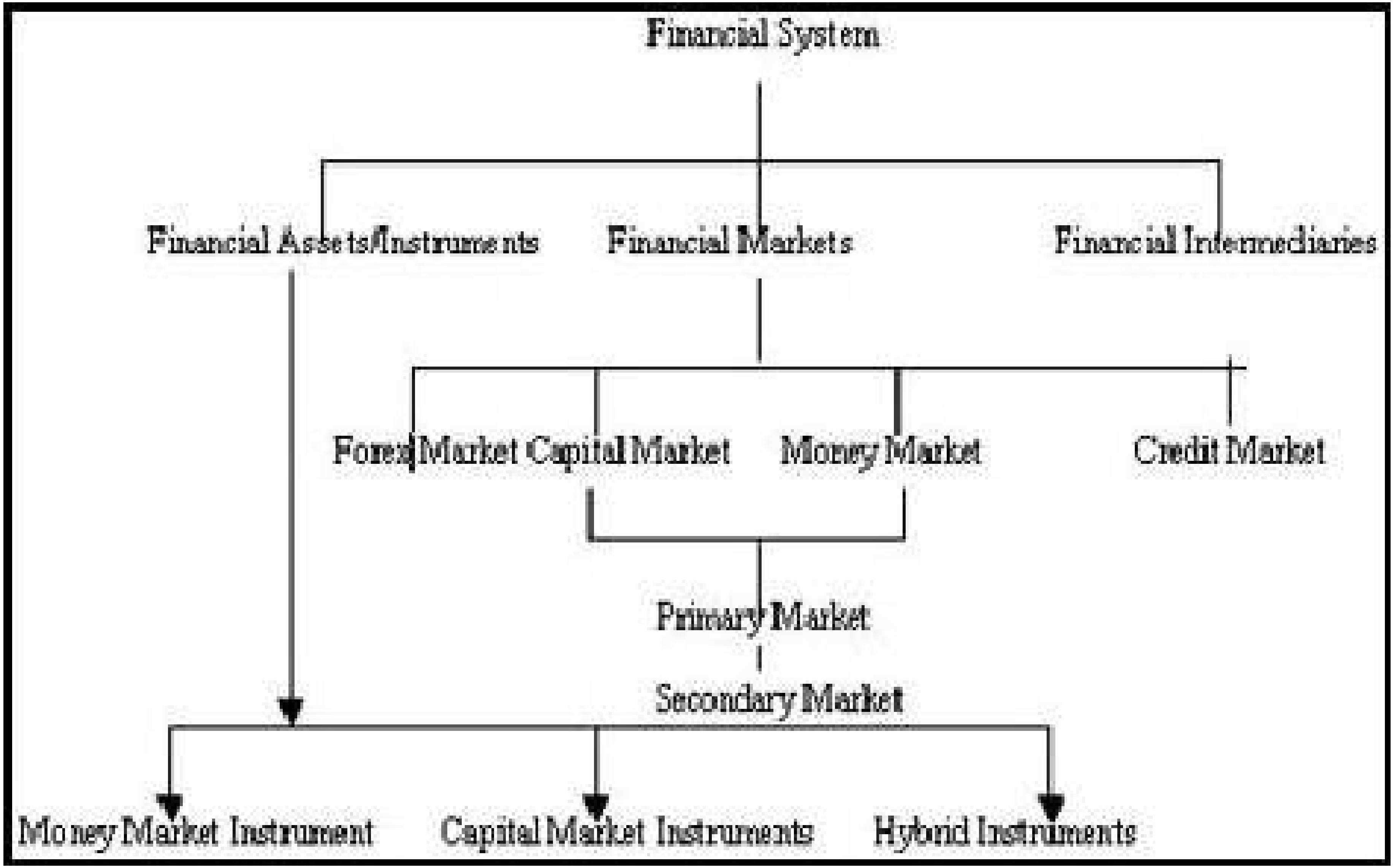
- There are areas or people with surplus funds and there are those with a deficit. A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit
- A Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities


Flow of funds (savings)
Seekers of funds (mainly business firms and government)
Suppliers of funds (mainly households)
Flow of financial services
Incomes, and financial claims

Financial System

- An institutional framework existing in a country to enable financial transactions
- Three main parts
  - Financial assets (loans, deposits, bonds, equities, etc.)
  - Financial institutions (banks, mutual funds, insurance companies, etc.)
  - Financial markets (money market, capital market, forex market, etc.)
- Regulation is another aspect of the financial system (RBI, SEBI, IRDA, FMC)
- Payment and Settlement System Plays a crucial role in it.

Constituents of a Financial System



Financial assets/instruments

- There are instruments for savers such as deposits, equities, mutual fund units, etc.
- There are instruments for borrowers such as loans, overdrafts, etc.
- Like businesses, governments too raise funds through issuing of bonds, Treasury bills, etc.
- Instruments like PPF, KVP, etc. are available to savers who wish to lend money to the government

FINANCIAL MARKETS

- A Financial Market can be defined as the market in which financial assets are created or transferred. As against a real transaction that involves exchange of money for real goods or services, a financial transaction involves creation or transfer of a financial asset. Financial Assets or Financial Instruments represents a claim to the payment of a sum of money sometime in the future and /or periodic payment in the form of interest or dividend

Money Market

- Money market refers to the market for short term assets that are close substitutes of money.
- It is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.

Organised Money Market

- Call money market
- Bill Market
  - Treasury bills
  - Commercial bills
- Bank loans (short-term)
- Organised money market comprises RBI, banks (commercial and co-operative)

Call Money Market

- In Call Money Market, day to day imbalances in the funds position of scheduled commercial banks are eased out. The call /notice money market has graduated into a broad and vibrant institution.
- Call/Notice money is the money borrowed or lent on demand for a very short period. When money is borrowed or lent for a day, it is known as Call (Overnight) Money. Intervening holidays and/or Sunday are excluded for this purpose.

Call/Notice Money Market

- If money is borrowed or lent for more than a day and up to 14 days, it is "Notice Money". No collateral security is required to cover these transactions.
- The entry into this field is restricted by RBI. Commercial Banks, Co- operative Banks and Primary Dealers are allowed to borrow and lend in this market.

Money Market Instruments

- Certificates of Deposit
- Commercial Paper
- Inter-bank participation certificates
- Inter-bank term money
- Treasury Bills
- Bill rediscounting
- Call/notice/term money
- CBLO
- Market Repo

Treasury Bills

- Treasury Bills are short term (up to one year) borrowing instruments of the union government. It is an IOU of the Government. It is a promise by the Government to pay a stated sum after expiry of the stated period from the date of issue (14/91/182/364 days i.e. less than one year). They are issued at a discount to the face value, and on maturity the face value is paid to the holder. The rate of discount and the corresponding issue price are determined at each auction.

Certificates of Deposit

- Certificates of Deposit (CDs) are negotiable term deposit certificates issued by a commercial banks/Financial Institutions at discount to face value at market rates, with maturity ranging from 15 days to one year.
- Being securities in the form of promissory notes, transfer of title is easy, by endorsement and delivery. Further, they are governed by the Negotiable Instruments Act. As these certificates are the liabilities of commercial banks/financial institutions, they make sound investments.

Commercial Papers

- CPs enable highly rated corporate borrowers to diversify their sources of short-term borrowings and raise a part of their requirement at competitive rates from the market.
- Commercial Papers are unsecured debts of corporate.
- They are issued in the form of promissory notes, redeemable at par to the holder at maturity. Only corporate who get an investment grade rating can issue CPs, as per RBI rules.

Forex Market

- The Forex market deals with the multi-currency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe.

Credit Market

- Credit market is a place where banks, FIs and NBFCs purvey short, medium and long-term loans to corporate and individuals.

Indian Banking System

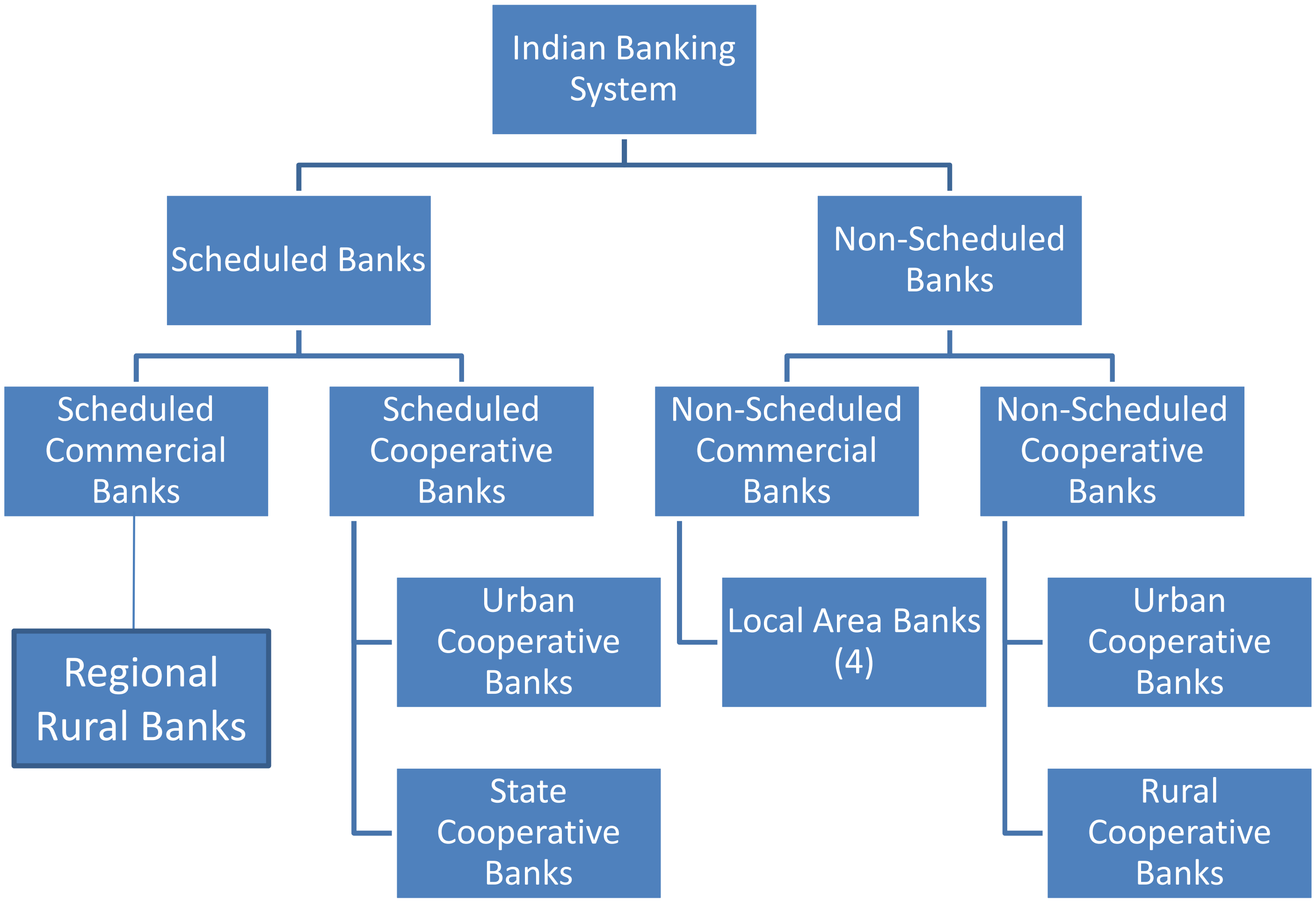
- Central Bank (Reserve Bank of India)
- Commercial banks
- Co-operative banks

Banks can be classified as:

  - Scheduled (Second Schedule of RBI Act, 1934)
  - Non-Scheduled

- Scheduled banks can be classified as:
  - Public Sector Banks
  - Private Sector Banks (Old and New)
  - Foreign Banks
  - Regional Rural Banks
  - Co-operative banks

Indian Banking System - Overview



Capital Market

- The capital market is designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year.

The Indian Capital Market

- Development Financial Institutions
  - Industrial Finance Corporation of India (IFCI)
  - State Finance Corporations (SFCs)
  - Industrial Development Finance Corporation (IDFC)
- Financial Intermediaries
  - Merchant Banks
  - Mutual Funds
  - Leasing Companies
  - Venture Capital Companies

Securities Market

- Refers to the market for shares and debentures of old and new companies
- New Issues Market- also known as the primary market- refers to raising of new capital in the form of shares and debentures
- Stock Market- also known as the secondary market. Deals with securities already issued by companies

Financial Intermediaries

- Mutual Funds- Promote savings and mobilise funds which are invested in the stock market and bond market
- Indirect source of finance to companies
- Pool funds of savers and invest in the stock market/bond market
- Their instruments at saver’s end are called units
- Offer many types of schemes: growth fund, income fund, balanced fund
- Regulated by SEBI

Financial Intermediaries….

- Merchant banking- manage and underwrite new issues, undertake syndication of credit, advise corporate clients on fund raising
- Subject to regulation by SEBI and RBI
- SEBI regulates them on issue activity and portfolio management of their business.
- RBI supervises those merchant banks which are subsidiaries or affiliates of commercial banks
- Have to adopt stipulated capital adequacy norms and abide by a code of conduct

Regulation and Supervision

- The regulatory framework in India has always been alive to the need for ensuring financial stability on an ongoing basis while fostering growth supporting financial market developments. One of the key factors that helped India to counter the impact of the crisis was the counter-cyclical regulatory environment and micro and macro prudential measures.

Developments in India

- Basel enhancements adopted
- Liquidity requirements through SLR
- Countercyclical prudential measures through risk weights and provisioning
- Guidelines on compensation
- New regulatory framework for financial conglomerates

Legal Frame Work for RBI

- Umbrella Acts:
- Reserve Bank of India Act, 1934: governs the Reserve Bank functions
- Banking Regulation Act, 1949: governs the financial sector

  Acts governing specific functions :
- Government Securities Act 2006: Governs government debt market
- Indian Coinage Act, 1906:Governs currency and coins
- Foreign Exchange Regulation Act, 1973/Foreign Exchange Management Act, 1999: Governs trade and foreign exchange market
- "Payment and Settlement Systems Act, 2007: Provides for regulation and supervision of payment systems in India"

Section 22 of BR Act-
Licensing of banking companies

- (1) No company shall carry on banking business in India unless it holds a license issued in that behalf by the Reserve Bank
- (3) Before granting any license under this section, the Reserve Bank may require to be satisfied by an inspection of the books of the company that the following conditions are fulfilled, namely:-

Section 22 of BR Act-
Licensing of banking companies…..

- (a) that the company is or will be in a position to pay its present or future depositors in full as their claims accrue;
- (b) that the affairs of the company are not being, or are not likely to be, conducted in a manner detrimental to the interests of its present or future depositors;

Section 22 of BR Act- Licensing of banking companies…..

- (c) that the general character of the proposed management of the company will not be prejudicial to the public interest of its present or future depositors;
- (d) that the company has adequate capital structure and earning prospects;
- (e) that the public interest will be served by the grant of a license to the company to carry on banking business in India;

Section 23 of BR Act- Restrictions on opening of new, and transfer of existing, places of business

(1) Without obtaining the prior permissions of the Reserve Bank-

- (a) no banking company shall open a new place of business in India or change otherwise than within the same city, town or village, the location of an existing place of business situated in India; and

Section 23 of BR Act- Restrictions on opening of new, and transfer of existing, places of business

- (b) no banking company incorporated in India shall open a new place of business outside India or change, otherwise than within the same city, town or village in any country or area outside India, the location of an existing place of business situated in that country or area:

Section 35 of BR Act
Inspection

(1) Reserve Bank at any time may, and on being directed so to do by the Central Government shall, cause an inspection to be made by one or more of its officers of any banking company and its books and accounts; and the Reserve Bank shall supply to the banking company a copy of its report on such inspection.

35A. Power of the Reserve Bank to give directions

- (1) Where the Reserve Bank is satisfied that-
- (a) in the public interest; or
- (aa) in the interest of banking policy; or
- (b) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositor or in a manner prejudicial to the interests of the banking company; or

Section 36of BR Act

Further powers and functions of Reserve Bank

- (1) The Reserve Bank may:
- (a) caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions, and generally give advice to any banking company;
- (b) on a request by the companies concerned and subject to the provisions of section 44A, assist, as intermediary or otherwise, in proposals for the amalgamation of such banking companies;

Section 45Q of BR Act - Power to inspect

- (1) The Reserve Bank shall, on being directed so to do by the Central Government or by the High Court, cause an inspection to be made by one or more of its officers of a banking company which is being wound up and its books and accounts.
- (2) On such inspection, the Reserve Bank shall submit its report to the Central Government and the High Court.

Section 45N of RBI Act- Inspection

- **1**[(1) The Bank may, at any time, cause an inspection to be made by one or more of its officers or employees or other persons (hereafter in this section referred to as the inspecting authority)-
- (i) of any non-banking institution, including a financial institution, for the purpose of verifying the correctness or completeness of any statement, information or particulars furnished to the Bank or for the purpose of obtaining any information or particulars which the non-banking institution has failed to furnish on being called upon to do so; or

Acts governing Banking Operations of RBI

- Companies Act, 1956:Governs banks as companies
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980: Relates to nationalisation of banks
- Bankers' Books Evidence Act
- Banking Secrecy Act
- Negotiable Instruments Act, 1881

SARFAESI Act

- Enables setting up of Asset Management Companies to acquire NPAs of any bank or FI (SASF, ARCIL are examples)
- NPAs are acquired by issuing debentures, bonds or any other security
- As a second creditor can serve notice to the defaulting borrower to discharge his/her liabilities in 60 days
- Failing which the company can take possession of assets, takeover the management of assets and appoint any person to manage the secured assets
- Borrowers have the right to appeal to the Debts Tribunal after depositing 75% of the amount claimed by the second creditor

Acts governing Individual Institutions regulated by RBI

- State Bank of India Act, 1954
- The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003
- The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993
- National Bank for Agriculture and Rural Development Act
- National Housing Bank Act
- Deposit Insurance and Credit Guarantee Corporation Act, etc.

SEBI Related Acts

- Securities and Exchange Board of India Act, 1992
- Securities Contracts (Regulation) Amendment Act, 2007
- The Depositories Act, 1996
- The Securities Contract (Regulations) Act 1956