BLOCK V:
FINANCIAL INSTITUTIONS AND SERVICE

Unit 1 : Financial Institutions/Intermediaries-Banking and Non Banking Financial Institutions and Their Service and Products

Unit 2 : Financial Services

Unit 3 : Regulating Framework for Financial System and Its Importance

Unit-1
Financial Institutions/Intermediaries-banking and Non Banking Financial Institutions and Their Service and Products

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1.1 Introduction

The financial system includes a range of institutions, markets and instruments. It provides the primary way by which savings are transformed into investments. Since its responsibility in the allocation of resources is crucial, the competent functioning of the financial system is of critical significance to a modem economy. Financial institutions are vital mechanism of the financial

structure. The key role of a financial establishment is to serve as an intermediary between lenders and borrowers. They assist smooth working of the financial system by establishing connection between the investors and borrowers and consequently help the allocation of funds in a resourceful way.

Financial institutions are component of organized financial system since they come in the beneath of the purview of Ministry of Finance (MOF), Securities Exchange Board of India (SEBI), Reserve Bank of India (RBI), , and other regulatory institutions.

1.2 Objectives

After going through this unit you will be able to–

- understand the meaning of Financial Institutions,
- know the importance and functions of Banking and Non Banking financial institutions,
- differentiate between the Banking and Non-Banking financial institutions.

1.3 Meaning & Definition of Financial Institution

Financial Institutions are the institutions which tender financial services for its customers or members. The most likely service is financial intermediation. The institutions include banks, insurance companies, trust, companies, and investment dealers etc.

Financial institution is defined as "an establishment that focuses on dealing with financial transactions, such as investment, loans and deposits." In simple words, the financial establishment is an organization which may be either profit or non-profit, that takes money from customers and directs it in any of a mixture of investment avenues for the advantage of both the customer and the organization.

According to Dr. LM. Bhole, "Financial institutions are business organizations that act as mobilisers and depositories of savings and as purveyors of credit or finance."

Financial institutions are also called as financial intermediaries. They are classified into

(a) Banking institutions.

(b) Non Banking Financial institutions or companies (NBFCs)

(a) Banking institutions or banks: Banks mobilize savings by accepting deposits and grating loans to the public and firms. They are called as creators of credit e.g. the RBI, commercial banks, cooperative banks, Regional rural banks etc.

(b) Non-banking institutions: Non Banking Financial institutions or companies (NBFCs) also mobilize financial wealth directly or indirectly from the public and provide funds in the form of loans but they don't create credit. They are also considered as purveyors of credit. For example; Insurance Corporation (LIC), Unit Trust of India (UTI) etc.

Financial institutions can also be divided into intermediaries and non-intermediaries. Financial intermediaries intermediate between savers and investors. They lend money in the form of loans along with mobilization of savings. All banks are intermediaries. Nonbanking intermediaries provide financial support for specific purpose, sectors, areas and regions. For example, non-banking institutions like LIC, GIC, UTI, PF channelize the funds from savers under a range of schemes and provide the money for investment.

1.3.1 Prominent Characteristics of Financial Institutions

From the above explanation, following are the prominent characteristics of financial institutions:

- They are organization as well as intermediaries.
- They mobilize savings into investment.
- They generate financial assets such as deposits, loans, securities etc.
- They consist of both banking and non-banking financial companies.
- They include both organized and unorganized organizations.
- They are regulated by the government and regulating authorities.

- They accept deposits.
- They provide different loans like commercial loans, real estate loans and mortgage loans.
- Financial institutions enable money to flow through the economy among customers, businesses and government.

1.3.2 Importance of Financial institution

Financial institutions are the prime institutions which lend loans for different economic activities. There are many benefits for having sound and robust financial institutions in a country. The importance of Financial Institutions is as follows:

- Provide funds: Financial institutions give funds for the investment as well as industrial activities.
- Infrastructural facilities: Financial institutions provide basic infrastructure needed for the development and endorsement of productive ventures.
- Promotional activities: Promotional activities are considered by the financial institutions to mobilize the funds, minimize the risk of selling financial securities, providing working and long term capital for the business and industries.
- Improvement of backward areas: Apart from the financial activities, financial organizations also undertake some social responsibilities to promote the backward areas.
- Planned development: Financial institutions undertake all structured developments in the view of economic growth of the state. All planned developments are synchronized with the government plan and social welfare.
- Promoting industrialization: Financial institutions are established to make the profit and uphold interest of its members; they speed up the industrialization to contribute industrial augmentation. They support industries by granting loans, project development and consultancy.

- Employment creation: Mobilizing the funds for investment, building of infrastructural amenities, and speeding up of industries generates employment to the educated as well as qualified people of the state.

1.4 Banking Institutions

Meaning of Bank: A bank is a financial organization that accepts deposits from the public and creates a demand deposit while giving loans as well.

Under Section 5 (1) (b) of the Banking Regulation Act 1949, banking is defined as "The accepting for the purpose of lending or investment, deposit of money from the public repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise."

1.4.1 Origin of Banking

The word bank is fundamentally derived from the Italian word BANCO, a bench – that means the Jews in Lombardy place for the exchange of money or bills. Banking is as old as is the genuine history. The existences of modern commercial banking are in ancient time, the seeds of bank are plant in ancient time.

1.4.2 Evolution of Banking in India

The existence of proficient banking in India could be traced to the 500 BC. Kautilya's Arthashastra (400 BC) contained references to lenders, creditors and lending rates. Banking was fairly diverse and catered to the credit necessities of the trade, commerce, agriculture, individuals and other agents of the economy. An extensive network of Indian banking institutions existed in the country involving all cities or towns that were of commercial significance. Evolution of banking in India can be studied under two main phase i.e., Pre-Independence phase and Post-Independence phase.

Pre-Independence phase:

- East India Company was established The Bank of Hindustan in the year 1770
- The General Bank of India was established in the year 1786
- Modern Commercial banking started in India with the founding of three presidency banks namely the Bank of Calcutta (1809), the Bank of Bombay (1840) and the Bank of Madras (1843)

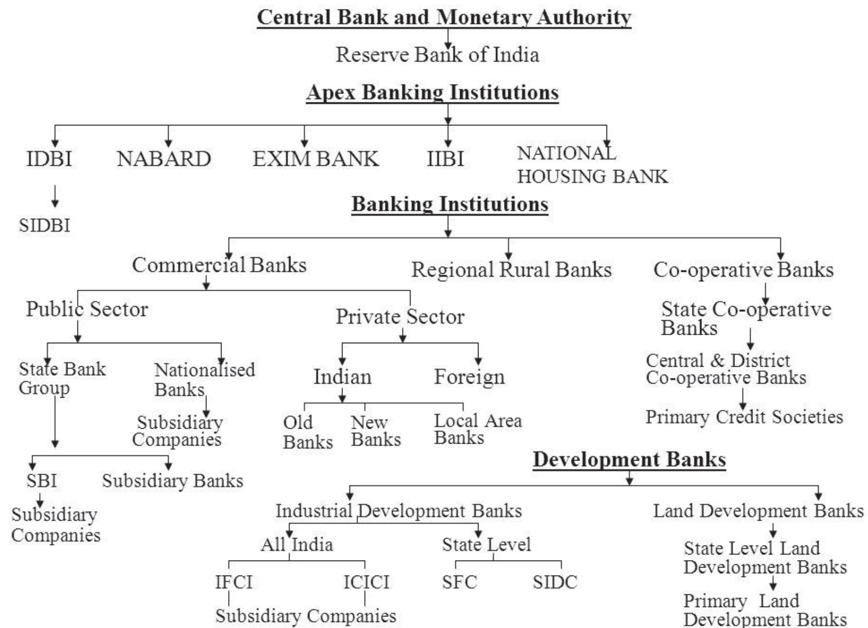
- In India, the Joint Stock Companies Act, 1850 was the first legislative that allowed the corporate sector to do the banking business.
- A great number of banks came into existence since the beginning of Swadeshi movement (1905) like Bank of India, Bank of Baroda, Punjab and Sind Bank etc.
- In 1921, three Presidency Banks were amalgamated to form a single bank named Imperial Bank of India.
- In 1935, the Reserve Bank of India (RBI) was established in 1935 as the Central Bank of India under RBI Act 1934

Post-Independence phase:

- Nationalization of Reserve Bank of India on 1st January 1949 under RBI Act 1934
- The Banking Companies Act 1949 was passed to protect the interest of depositors and to guarantee the appropriate progress of commercial banks in India.
- In 1955, Imperial Bank of India was nationalized and renamed as State Bank of India.
- Nationalization of 14 Commercial Banks in 1969 and another 6 Commercial Banks were nationalized in 1980.
- In 1975 Regional Rural Banks were established with focal point for the development of rural and agricultural sector.

Indian banking industry is subject to the regulations of the Central Bank of India i.e., RBI. RBI being the apex institution supervises, regulates and promotes the monetary system as well as the financial system of the country. Banking Regulation Act, 1949 is the main legislation governing commercial banks in our country India.

1.4.3 Structure of banking institution in India



The Indian banking institutions can be broadly classified into two categories:

1. Organized Sector

2. Unorganized Sector.

1. Organized Sector:

The organized banking sector consists of commercial banks, cooperative Banks, the Regional Rural Banks and Development Banks.

(a) Commercial Banks: Commercial Banks accept deposits from the general public and advance loans with the purpose of earning profits. The commercial banks may be classified as scheduled banks or non-scheduled banks. Banks which are included in the II schedule of the Reserve Bank of India Act, 1934 are scheduled banks. All banks which are not included in the II schedule of the Reserve Bank of India Act, 1934 are Non-scheduled Banks. Except for emergencies, non-scheduled Banks are not eligible to take loans from the RBI for normal banking purposes.

(b) Co-operative banks: Co-operative banking is another vital section of the organized sector of Indian banking system. They are represented by a group of societies registered under the Cooperative Societies Acts of the respective state. In actuality, co-operative societies are either credit societies

or non-credit societies. In India, different co-operative credit societies are operating. These banks can be classified into two wide categories :(a) Rural credit societies- that are primary agriculture, (b) Urban credit societies which are mainly non-agriculture. For the purpose of agriculture credit there are different co-operative credit institutions to meet up different needs.

(c) Regional Rural Banks (RRBs): Regional Rural Banks were established by the state government and some sponsoring commercial banks with the purpose of promoting the rural economy under the Regional Rural Banks Act, 1976. RRBs were founded with the aim of ensuring adequate institutional credit for agriculture and allied rural sectors. Regional Rural Banks provide banking services and credit to small and marginal farmers as well as entrepreneurs in the rural areas. They represent a significant element of the rural financial planning in India.

(d) Foreign Banks: Foreign banks are banks that have branches in the other countries and main head office in the Home Country. A number of foreign banks have entered India with the deregulation (Elimination of Government Authority) in 1993. Some examples of Foreign Banks are: Citi Bank, Bank of Ceylon etc.

(e) Development Banks: Financial institutions that give long-term credit to promote capital-intensive investments spread over a long period and yielding lower rates of return with substantial social benefits are known as Development Banks. The primary development banks in India are; Industrial Finance Corporation of India (IFCI Ltd), 1948, Industrial Development Bank of India' (IDBI) 1964, Export-Import Banks of India (EXIM) 1982, Small Industries Development Bank of India (SIDBI) 1989, National Bank for Agriculture and Rural Development (NABARD) 1982 etc.

2. Unorganized Sector.

Participants in the unorganized banking sector are mainly the Indigenous Bankers & Money Lenders.

a. Indigenous Bankers: Indigenous Bankers are private firms or individual those operate as banks and as such both accept deposits and grant loans. They are also financial intermediaries like banks. They are supposed to be well-known professional money lenders whose principal business is not banking or money lending. The indigenous bank normally deals with the Hundies, Commercial Paper etc.

b. Money Lenders: Money lenders completely depend on their own fund. They may be rural or urban, professional or non-professional. They consist of large number of farmer, traders, and merchants. Operations of money lenders are unregulated. Money lenders normally charge very high rate of interest on their lending.

Check Your Progress

1. Financial institutions are component of organized financial system. (True or False)
2. The word bank is fundamentally derived from the Italian word …………(Fill in the blanks)
3. What is a scheduled bank?

1.4.4 Functions of a Bank

There are mainly two types of functions of banks. They are:

1. Primary functions
2. Secondary Functions

All banks perform two types of major primary functions namely:

1. Accepting deposits
2. Providing loans and advances

Accepting of Deposits:

A very basic yet significant purpose of all the commercial banks is to mobilize public funds, offer safe custody of savings & interest on the savings to their depositors. Bank accepts varied types of deposits from the public. They are:

a. Saving Deposits: Bank promotes saving habits amongst the public. It is appropriate for salary and wage earners. The rate of interest on saving deposit is low. There is no constraint on the amount and number of withdrawals. The saving deposit accounts can be opened in a single name or in joint names also. The depositors just require to maintain the minimum balance that varies from bank to bank. Bank also provides ATM cum debit card, cheque book, and Internet banking facility. .

b. Fixed Deposits: It is also well-known as Term Deposits. Money is deposited for a fixed period. Withdrawal of money is not allowed during this period. In case depositors withdraw prior to maturity, banks charge a penalty for premature withdrawal. The rate of interest is high in case of Fixed deposit as a lump-sum amount is paid at one time for a specific period but interest rate varies with the period of deposit.

c. Current Deposits: Current deposits are mainly opened by traders and businessmen. The account holders can avail an overdraft facility on current deposit account. These deposits also act as a short term loan to meet working capital need or any other urgent needs. Bank charges a high-interest rate on current deposit along with the interest charges for overdraft facility. It is to maintain a reserve for unknown demands for the overdraft.

d. Recurring Deposits: In case of recurring deposit a certain sum of money, at a regular interval, is deposited in the bank. Money can be generally withdrawn only after the expiry of a pre specified period. In case of recurring deposits, a higher rate of interest is paid as it provides an effective gain of compounded rate of interest and enables depositors to accumulate a large amount of money. This type of account is mainly operated by petty traders and salaried persons.

Providing of Loans & Advances:

Banks provides loans to meet the needs and uncertainties of the businesses and individuals, out of deposits collected from the public. Bank takes a higher rate of interest on loans and advances than the rate of interest it gives on deposits. Profit for the bank is the difference between the interest rate on loans given and the interest rate for deposits accepted.

Bank generally offers the following types of Loans and Advances to various needy groups:

a. Bank Overdraft: Bank Overdraft is a kind of loan for the current account holders. This loan permits borrowers to withdraw money at anytime more than available balance in bank account but up to a specified limit. An overdraft facility is approved against some collateral security. The interest for overdraft is charged only on the borrowed amount for the period for which the loan is provided.

b. Cash Credits: Cash credit is short term loan facility up to a definite limit fixed in advance. Banks permit the customer to obtain a loan against a mortgage of assured property (tangible assets and guarantees). Cash credit is provided to any type of account holders and also to those who don't have a bank account with a bank. Interest is levied on the amount withdrawn in excess of the limit of the cash credit. In case of cash credit, generally a larger amount of loan is allowed than that of overdraft for a longer period.

c. Loans: Bank advances money against tangible assets to the customer for a short term or medium term periods of say 1 to 5 years. Nowadays, banks also provide loans for the long term. The borrower repays the loan amount either in a lump-sum amount or in the form of installments as per terms spread over a pre-decided duration. Whether withdrawn or not, bank takes interest on the actual amount of loan sanctioned. The interest rate of loans is generally lower than the overdrafts and cash credits facilities.

d. Discounting the bill of exchange: This is a kind of short term loan. In case of discounting of bills of exchange, the seller discounts the bill from the bank for some commission or fees at some specified rate. The bank advances money to the borrowers by discounting or purchasing the bills of exchange. Bank pays the bill amount to the drawer (seller) on behalf of the drawee (buyer) by deducting specified discount charges. The bank presents the bill to the drawee or acceptor to collect the bill amount on maturity.

Secondary Functions of Bank:

Secondary functions of banks are also classified into two parts:

1. Agency functions
2. Utility functions

Agency Functions of Bank:

Banks are the agents for their customers; hence it has to carry out a variety of agency functions as given below:

- Transfer of Funds: Banks transfer funds from one branch to another branch. Inter bank fund transfer is also provided.

- Annuity or Periodic Collections: Bank also gives service like collecting dividend, wages, salary, pension, and similar annuity or periodic collections on the behalf of clients.
- Annuity or Periodic Payments: Banks also provide services of making annuity payment or periodic payments of rents, electricity bills, etc on behalf of the client.
- Collection of Cheques: Banks also provide the service of collecting money from the bills of exchanges. The bank collects the money of the cheques on behalf of the customers through the clearing and settlement section of its customers.
- Portfolio Management: Banks supervise the portfolio of their customers or clients. They undertake the activity to purchase and sell the shares and debentures of the clients by debiting or crediting the customer's account.
- Other Agency Functions: Under agency functions, bank performs as a representative of its customers or clients for other institutions. Banks act as an executor, administrators, advisers, trustee, etc. of the customers.

Utility Functions of Bank:

- Bank issues letters of credit, traveller's cheque, etc to its customers.
- Bank provides safe deposit vaults or lockers for safe custody of valuables, important documents, and securities to its customers.
- Bank provides customers with services of foreign exchange dealings.
- Bank provide the service of underwriting of shares and debentures under merchant banking.
- Banks deal in foreign exchanges and charge fees.
- Banks also run social welfare programmes for the benefit of customers and society
- Bank prepares project reports
- Bank gives standing guarantee on behalf of its customers.

1.4.5 Role of a Banking Institution in the Economic Development of a Nation can be Discussed as Follows

- Formation of capital - Commercial banks endorses savings and investment that help to reduce capital paucity. They put these resources to productive use, boosting capital construction in the country.
- Creation of Credit - Apart from escalating the money in circulation, bank deposits also make their means to industries, to help them to generate productive assets. This credit has a multiplier impact on the economy.
- Trading functions: Commercial banks are allowed to function as market makers for government, municipal and corporate bonds. Banks can give issuers with counseling, advisory, and technical direction through their market-making actions.
- Growth of entrepreneurship: Banks provide capital to entrepreneurs and invest in productive purposes; banks promote self-sufficiency, lessen joblessness and encourage the right industries.
- Mobilization of savings: Commercial banks are a secure place to save money in the form of deposits.
- Funds transfer: Commercial banks help in sending funds to anywhere in India or abroad easily.
- Wealth creation: By providing consulting and advisory services, bank experts can direct investors to mutual funds or direct investments. The bank can operate as custodian for all investment securities, and provide safety deposit boxes, letters of credit for investment opportunities, as well as act as a trustee for wills and investment funds.

Stop to Consider

A Developed financial system is one of the essential factor for a developed economy. The country with a undeveloped or under developed financial system will not be in a position to declare itself as a developed country . Do you agree with the statement.

1.5 Non Banking Financial Institutions

1.5.1 Meaning & Concept

Non- Banking Financial Intermediaries (NBFIs) play a significant role of adding to the rate of development of financial market. Because of which the rate of economic development of a country is accelerated. NBFIs play an important role in escalating saving and investment. It influences the economy by mobilization savings, filling the credit gaps and channelizing the investments in proper directions. Indian financial intermediaries are mostly privately owned, decentralized and relatively small sized. Some of the NBFIs are engaged in fund based business while others offer financial services to the investors.

There has been an essential transformation in the functioning of NBFCs since post 1995 period. There were many small NBFCs working in India, whose information is not available. NBFCs perform a wide range of functions and they also provide financial services to the investors. NBFI as a financial intermediary, also keep up safety and liquidity in the procedure of resource mobilization. They play a significant role in the saving - investment process by increasing the level of saving and investment and by proper allotment of savings in productive investments. Many a times, commercial banks have the limitations to fulfill the financial requirements of a country and its investors. This leaves a room for growth to the Non - bank financial companies.

Meaning: Non - Bank Financial Companies is a group of intermediaries other than commercial bank and cooperative banks. They comprise institutions like insurance companies, merchant banks, development banks, etc.

The RBI (Amendment) Act, 1997 defines NBFCs as "an institution or company whose principle business is to accept deposits under any scheme of arrangement or in any other manner and lend in any manner."

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares, stocks, bonds, debentures, securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

1.5.2 Classification of Non- Banking Financial Companies (NBFCS)

On the basis of Liability Structure: On the basis of liability structure, the NBFCs may be divided into two categories. They are NBFCs accepting public deposits (referred to as NBFCs-D), and NBFCs that doesn't raise public deposits (known as NBFCs-ND).

1. Deposit taking NBFCs (known as NBFCs-D): These NBFCs are subject to the requirements of Capital adequacy norms, liquid assets maintenance norms, Exposure norms (including limits on exposure to investments in land, building and unquoted shares), Asset Liability Management (ALM) discipline and other reporting requirements.
2. Non-Deposit taking NBFCs (referred to as NBFCs-ND): Till 2006, NBFCs-ND was subject to minimal regulations. However, since 2007, NBFCs-ND with assets Rs 100 crores and above is being categorized as Systemically Important Non-Deposit taking NBFCs (NBFCs-ND-SI).

Currently, in the light of the overall augment in the development of the NBFC sector, the threshold for defining systemic significance for NBFCs-ND (non-deposit taking NBFCs) has been revised. Accordingly, the NBFCs-ND-SI will henceforth be the NBFCs-ND which have asset size of Rs 500 crore and above as per the last audited balance sheet.

Thus, the NBFCs-ND shall be categorized into two broad categories in accordance with the revised limit for systemic significance:

- NBFCs-ND (with assets of less than Rs 500 crore)
- NBFCs-ND-SI (with assets of Rs 500 crore and above).

The prudential regulations like capital adequacy and risk exposure norms in addition to reporting requirements have been made pertinent to the NBFCs-ND-SIs. At different points of time the ALM reporting and disclosure norms have also been made applicable to NBFCs.

NBFCs can be classified into the following classifications on the basis of nature of primary actions performed:

1. Asset Finance Company: Asset Finance Company is a company that finances physical assets that support productive or economic activities in addition to general purpose assets.
2. Leasing company: Leasing Company is a company that does the business of leasing of equipments or the financing of such activity.

3. Investment company: Investment companies are the companies that do the business of acquisition of securities on some fee basis.

4. Loan company: Loan company is a financial organization that provides loans or advances or otherwise for any activity other than its own. It does not comprise of an Asset Finance Company.

5. Infrastructure finance company: It is a company which carries on as its principle business, the financing of the acquisition or construction of infrastructure facilities of various kinds.

6. Infrastructure Debt Fund Company: Infrastructure Debt Fund Company is a company registered as NBFC to assist the flow of long term debt into infrastructure development projects.

7. Venture capital company: Venture Capital Company is a company that provides funds for seed capital to new business ventures.

8. NBFC-Factor is a non-deposit taking NBFC that mainly engage in the business of factoring.

9. NBFC- Non-Operative Financial Holding Company (NOFHC): NOFHC is a financial organization through which promoter or promoter groups will be allowed to set up a new bank .It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent allowable under the appropriate regulatory guidelines.

Distinction between Bank and NBFCs:

NBFCs are not banks, even though this is a common misconception. Following are the differences between Banks and NBFCs:

Basis of Difference	Banks	NBFCs
1. Licensing and Regulation	Banks are licensed financial organizations regulated by the government under the Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949.	NBFCs are not authorized; they are licensed financial institutions. They are constituted as per the Companies Act and regulated by the Reserve Bank of India Act of 1934.
2. Types of Services	Banks give services in loan advancements, remittance of funds, guarantees, credit card facilities, cheque payments, etc.	NBFCs give services such as savings and investment plans, insurance facilities, mutual funds, stocks, etc.
3. Deposit Function,	The main function of banks' business is accepting deposits and advancing loans.	NBFCs deal in deposits in the system of securitization.
4. Acceptance of Demand Deposits	Banks accept deposits repayable on demand.	NBFCs are not allowable to accept demand deposits.
5. Extend Foreign Investment	A foreign investment up to 74% is allowed in case of Bank.	A foreign investment up to 100 % is allowed in case of NBFCs.
6. Payment and Settlement Cycle	Banks are part of the payment and settlement system.	NBFCs are not a part of payment and settlement system.
7. Maintenance of CRR and SLR	Banks should maintain ratios like Cash Reserve Ratios (CRR) and Statutory Liquidity Ratios (SLR) as per the rule.	NBFCs need not to maintain CRR and SLR.
8. Facility of DICGC	Banks' Facility has deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation (DICGC).	NBFCs have no such access to this kind of facility.
9. Creation of Credits	Banks are involved in creating credits.	NBFCs can't create credit.
10. Provision of Transactional Services	Banks usually give transactional services like deposits, cash withdrawals, cheques, debit card payments, or online payments.	NBFCs do not give such types of monetary service.

1.5.4 Registration & Regulation of NBFC

NBFC registration refers to the procedure by which a non-banking financial company (NBFC) obtains authorization and permission from the regulatory authority, normally the Reserve Bank of India (RBI) in India, to operate as a financial organization and give certain financial services to the public. The registration procedure involves fulfilling specific conditions, submitting required documents, fulfilling regulatory guidelines, and complying with financial and operational norms set by the regulatory authority. After registration, an NBFC can engage in financial activities such as lending, investment, and other financial services, subject to the regulations and guidelines provided by the regulatory authority.

To regulate and govern the functioning and operations of non-banking financial companies (NBFCs), NBFCs need to comply with some set of rules, guidelines, and norms established by regulatory authorities, such as the Reserve Bank of India (RBI) in India,

- Regulatory Authority: NBFC regulations are overseen by regulatory bodies like the Reserve Bank of India (RBI) in India.
- Licensing and Registration: NBFCs are required to obtain proper licenses and registration from the regulatory authority to operate legally.
- Capital Adequacy: NBFCs are required to maintain a fixed level of capital to ensure financial stability and solvency.
- Asset Classification: Regulations prescribes NBFCs categorize their assets and loans, ensuring transparency and risk assessment.
- Risk Management: NBFCs must have sufficient risk management strategies in place to lessen financial risks.
- Corporate Governance: Regulations focus on good governance practices including transparency, board composition and accountability.
- Prudential Norms: NBFCs have to fulfill specific norms related to income recognition, and provisioning lending practices.
- Disclosure Requirements: NBFCs are needed to reveal financial information at regular interval to provide transparency to investors and stakeholders.
- Interest Rates: Regulations often guide NBFCs on the maximum interest rates they can charge on loans.
- Anti-Money Laundering (AML) and KYC: NBFCs need to implement AML and Know Your Customer (KYC) policies to prevent illegal activities and ensure customer identification.

1.5.5 Functions or Services of NBFCs

NBFCs play a significant role in diversifying the financial landscape by offering a wide range of services that complement traditional banking services. Here are the functions of Non-Banking Financial Companies (NBFCs):

- Financial Intermediation: Without being full-fledged banks, NBFCs act as intermediaries between borrowers and lenders and give various financial services.
- Credit Provision: NBFCs give loans and credit to individuals, businesses, and sectors that might have limited access to traditional banking services.
- Investment Activities: NBFCs invest in various financial assets such as stocks, bonds, mutual funds, and other securities.
- Leasing and Hire-Purchase: NBFCs offer services like leasing and hire-purchase, allowing individuals and businesses to obtain assets without the immediate need for bulky upfront payments.
- Factoring and Bill Discounting: NBFCs give factoring services to the lenders where they purchase accounts receivable from debtors and other businesses to provide immediate funds, to ensure efficient cash flow management.
- Insurance Services: Some NBFCs offer insurance-related services, particularly in rural areas, to give coverage to those that are underserved by traditional insurance companies.
- Foreign Exchange Services: Certain NBFCs give forex services for individuals and businesses that need currency exchange and fund remittance.
- Microfinance: NBFCs give microfinance services to financially underserved sections of the society, mainly in rural areas, by giving small loans and other financial products.
- Advisory Services: NBFCs offer financial advisory services like helping clients with financial planning, investment decisions, and other portfolio management services.
- Mortgage Services: NBFCs give mortgage loans to individuals to buy or develop real estate assets and properties.
- Vehicle Finance: Both for personal use and commercial purposes, NBFCs give loans for purchasing vehicles,
- Retail Financing: They give loans and advances for consumer goods, electronics, furniture and other retail products through partnerships with retailers.

Check Your Progress

1. Overdraft is a kind of loan for the current account holders/ savings account holders. (Chose the correct option)
2. Portfolio Management is a _________function of a bank. (Chose the correct option)

   a. Primary b. General Utility c. Agency
3. NBFCs need not to maintain CRR and SLR. (True or False)

1.6 Summing Up

1. The financial system includes a range of institutions, markets and instruments. It provides the primary way by which savings are transformed into investments. The key role of financial system is to serve as an intermediary between lenders and borrowers.
2. Financial institutions are vital mechanism of structure. A financial institution is a business entity that provides services such as accepting deposits, lending, and investment products to individuals, businesses, or both. The institution includes banks, insurance companies, trust, companies and investment dealers etc.
3. The importance of financial institutions is that it provide funds, infrastructural facilities, promotional activities, improvement of backward areas, planned development, promoting industrialization, employment creation.
4. There are two types of financial institution a) Banking Financial Institution b) Non Banking Financial Institution. Banking financial institutions are the financial institutions that provide various banking facilities such as accepting of deposits and granting of loans and advances to corporation. Non banking financial institution do not hold any banking licenses and cannot accept deposits from public or grant loan or advances to public.
5. Types of banking financial institution are a) commercial bank b) central bank c) regional rural bank d) investment bank e) foreign bank. Types of non banking financial institutions are a) leasing company b) loan company c) investment company d) hire purchase company e) chit fund f) asset finance company.

1.7 Model Questions

1. What is a bank? Write the differences between schedule and non schedule bank.
2. Discuss the role of Financial institutions in the economic development of a country
3. What are differences between Banks and NBFCs? Write.
4. Write a note on the regulations of NBFCs.

1.8 References and Suggested Readings

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Unit-2
Financial Services

Unit Structure:

2.1 Introduction
2.2 Objectives
2.3 Concept and Meaning of Financial Services
2.4 Characteristics of Financial Services
2.5 Functions of Financial Services
2.6 Importance/Significance of Financial Services
2.7 Types of Financial Services
2.7.1 Traditional Financial Services:
2.7.2 Modern Financial Services
2.8 Evolution of Financial Services in India
2.9 Recent trends in the Financial Service sector in India.
2.10 Summing Up
2.11 Model Questions
2.12 References and Suggested Readings

2.1 Introduction

Financial services are a crucial element of our economic framework, encompassing a wide array of activities such as banking, insurance, investment, brokerage, and consumer finance. Essentially, any financially related activities fall under this category. Broadly speaking, these services involve the mobilization and allocation of savings, transforming them into investments. This process, known as financial intermediation, involves gathering funds from numerous savers and providing them to those in need, particularly corporate clients. The financial services sector is pivotal for industrial growth, catalyzing economic development. A well-established financial services industry is essential for gathering and distributing savings to various investment avenues, thereby fostering industrial progress within a nation. Without financial services, the financial system cannot function effectively. These organizations act as intermediaries, channelling funds from surplus units to deficit ones. Certain services require immediate financial commitment, while others necessitate support and guarantees without immediate fund involvement.

2.2 Objectives

After going through this unit you will be able–

- *understand* the concept and meaning of Financial Service,
- *explain* the Characteristics and functions of Financial Service,
- *discuss* the Importance and types of financial services in India,
- *analyse* the evolution and recent trends in the financial sector in India.

2.3 Concept and Meaning of Financial Services

The concept of financial services has been around for centuries, but it gained significant recognition in the past 25-30 years. Although there isn't a single, straightforward definition for financial services, in the UK context, it encompasses banking, insurance, stock broking, investment services, and various other business and professional services. Essentially, financial services ensure the smooth flow of financial activities within the economy. They are a vital part of the financial system, catering to the needs of financial institutions, markets, and instruments designed for both individual and institutional investors. Financial institutions and markets play a crucial role in the financial system by facilitating various financial instruments. To accomplish their tasks effectively, they require a range of financial services. Hence, financial services are considered the fourth essential element of the financial system. The efficiency and effectiveness of these services provided by financial institutions significantly influence the functioning of the entire financial system.

Financial services encompass a wide range of activities related to the management of money, involving the mobilization and allocation of savings. These services, provided by the finance industry, include activities transforming savings into investments. Financial services are offered by various organizations like banks, credit card companies, insurance firms, consumer finance entities, stock brokers, investment funds, and certain government-sponsored enterprises. Essentially, financial services facilitate diverse financial transactions and related activities. The process, also known as financial intermediation, involves gathering funds from numerous savers and providing them to those in need, especially corporate clients.Different institutions, such as banks, investment firms, accounting companies, and venture capital entities, offer these services. They cater to corporate

enterprises, aiding in their financial transactions and market operations. The services provided by these financial intermediaries to businesses and consumers are collectively referred to as financial services. These services and facilities are vital for the smooth functioning of financial markets. To put it succinctly, the services delivered by financial intermediaries are known as financial services.

Check Your Progress

1) The financial services can also be called as……………….

2) Services provided by financial intermediaries are called…………

2.4 Characteristics of Financial Services

Financial services encompass a wide range of services provided by the finance industry, including banking, insurance, investment, real estate, and other related activities. These services are essential for individuals, businesses, and governments to manage their financial resources effectively. Here are some key characteristics of financial services:

Customer orientation: Like any other service industry financial service industry is also a customer-oriented one. That customer is the king and his requirements must be satisfied in full and should be the basic tenant of any financial service industry. It calls for designing innovative financial products suitable to the varied risk-return requirements of customers. Above all, there should be timely delivery of services.

Intangibility: Financial Services are intangible and therefore, they cannot be standardised or reproduced in the same form. Hence, there is a need to have a track record of integrity, reputation, good corporate image and timely delivery of services.

Simultaneous Performance: Yet another feature is that both production and supply of financial services have to be performed simultaneously. Therefore, both suppliers of services and consumers should have a good rapport, clear-cut perception and effective communications

Dominance of human element: Financial Services are dominated by human elements and thus, they are people-intensive. It calls for competent and skilled personnel to market quality financial products. But, quality cannot be homogenised since it varies with time, place and customer-to-customer.

Perishability: Like any other service, financial services are also perishable. These services also strike a match between demand and supply. Like other regular services, they cannot be stored and will have to be offered as and when they are demanded by the customers.

Inseparability: There is no separation between financial service providers and their offerings. The production of financial services and their provision take place concurrently.

Customization: The range of products and services offered by financial services is very individualised. Various levels of advising services are also a part of providing financial services. These components require customization. Every client is different when it comes to these services. Financial services are heterogeneous, to put it simply.

Professional Knowledge and Experience: A lot of financial services call for certain training and experience. Experts like accountants, insurance agents, and financial consultants are essential in assisting clients in making wise financial decisions.

Electronic Delivery: Thanks to technological developments, a large number of financial services are now provided electronically via mobile apps and web platforms. This has had a substantial impact on how customers use and interact with financial services.

To effectively traverse the complexity of the financial services business, consumers and service providers must have a thorough understanding of these qualities.

2.5 Functions of Financial Services

Any economy relies heavily on financial services to facilitate the effective distribution of resources and promote economic expansion. These services cover a wide range of industries, including banking, insurance, real estate, and investments. Each of these industries performs a specific role that is essential to the operation of governments, enterprises, and individuals.Following are some of the key functions of financial services.

Capital Allocation and Investment: The distribution of capital is one of the main roles of financial services. Financial intermediaries mobilise money from savers to borrowers, enabling companies to make investments in initiatives, R&D, and projects. This process generates jobs and encourages

innovation, which not only supports entrepreneurial endeavours but also boosts economic growth.These funds can be mobilized through financial instruments like shares, bonds & debentures, mutual funds etc.

Risk Management: Financial services provide essential tools for managing risks. Insurance companies, for instance, mitigate the financial impact of unpredictable events such as accidents, natural disasters, and health emergencies. Additionally, financial markets offer derivatives and hedging instruments that enable businesses to safeguard against volatile commodity prices and currency fluctuations, ensuring stability in the face of uncertainty.

Wealth Management and Financial Planning: Financial services play a crucial role in wealth management and financial planning. Wealth advisors and asset managers assist individuals and organizations in optimizing their financial portfolios, ensuring long-term growth and stability. These services include investment advice, retirement planning, estate management, and tax optimization, empowering clients to make informed decisions about their financial futures.

Payment Services: Financial institutions offer payment services, enabling individuals and businesses to conduct transactions. These services include checking and savings accounts, electronic funds transfers, credit and debit cards, online banking, and mobile payment apps, making financial transactions more convenient and efficient.

Borrowing and Lending: Financial institutions, particularly banks, facilitate borrowing and lending activities. They provide loans and credit to individuals and businesses, supporting various purposes such as education, home purchases, and business expansions. These services promote economic activities and consumer spending.

Financial Intermediation: Financial institutions act as intermediaries between savers and borrowers. They collect funds from savers and lend these funds to borrowers, earning profits through the interest rate spread. This intermediation process ensures efficient use of funds and liquidity in the economy.

Regulatory Compliance: Financial services providers adhere to regulatory standards and compliance requirements set by government authorities. They ensure legal and ethical practices, protecting consumers and maintaining the stability and integrity of the financial system.

Financial services are the lifeblood of modern economies, serving as catalysts for growth, innovation, and stability. Through their diverse functions, these services enable capital allocation, manage risks, facilitate transactions, support wealth management, implement economic policies, and promote financial inclusion. As economies continue to evolve, the functions of financial services will adapt to meet the changing needs of societies, ensuring sustainable development and prosperity for all. Embracing the transformative power of financial services is essential for fostering economic resilience and improving the quality of life worldwide.

2.6 Importance/Significance of Financial Services

Financial services meet the requirements of individual and corporate clients. In fact, the proper working of any financial intermediaries is based on the variety of financial services provided by the service provider. Financial services can be defined to include not only the provisions of financial services but also sales of financial products or both. The importance or significance of financial services can be realized from the following:

Economic Growth: The financial services sector mobilizes people's savings and directs them towards productive investments by providing various services to people. In fact, the economic development of a nation depends on these savings and investments.

Promotion of savings: The financial services institutions promote savings in the country by providing transformation services. It provides transformation services for assets, activities and dimensions by granting large loans based on numerous small deposits. It also provides maturity transformation services by offering short-term credits to savers in their liquid deposits and providing long-term loans to borrowers.

Capital formation: The financial services industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the very basis for economic growth. It is the principal mobiliser, of financial assets into liquid cash at the discretion of the holder of such assets.

Provision of liquidity: The financial service industry facilitates capital formation by rendering various capital markets intermediary services. Capital formation is the very basis for economic growth. It is the principal mobiliser, of surplus funds to finance productive activities and thus, it promotes capital accumulation.

Financial Intermediation: The financial service industry facilitates the function of intermediation between savers and investors by providing a means and a medium of exchange and by undertaking innumerable services.

Contribution to GNP: The contribution of financial services to GNP has been going on increasing year after year in almost all countries in recent times.

Creation of employment opportunities: the financial services industry creates and provides employment opportunities to millions of people all over the world.

The significance of financial services lies in their ability to drive economic growth, facilitate innovation, manage risks, promote entrepreneurship, alleviate poverty, and enhance the overall well-being of individuals and societies. They are fundamental to creating a stable, prosperous, and interconnected global economy.

Check Your Progress

1) What characteristic of financial services calls for designing innovative financial products suitable to the varied risk-return requirements of customers?
2) Financial intermediaries mobilise money from ………… to ………………

2.7 Types of Financial Services

Although there is no such scheme of classification of financial services which may satisfy everyone or is able to cover all the subtleties of this industry. However, in order to understand the functioning of the financial services industry in a better perspective we have tried to organize our discussion of the financial services industry by classifying the financial services under two broad categories, i.e. traditional financial services and modern financial services (Kulkarni, Joshi, Mutreja, Narayanan, & Memon, 2022)

2.7.1 Traditional Financial Services: All financial services that serve the capital and money markets are considered traditional. There are two categories into which traditional financial services can be further divided: a. fund-based services and b. fee-based financial services.

a) Fund-based financial services: Fund Based Services are financial services in which there is the direct commitment of funds by the service rendering houses.The fund of institutions is directly engaged in such services including as underwriting of investments in securities like shares and debentures, bonds, new issue etc., dealing in secondary market activities, participating in money market instruments like commercial papers, certificate of deposits (COD), treasury bill, discounting of bill and dealing in foreign exchange market activities with all short term medium term and long term loan. In layman'sterms fund fund-based services can be understood by various types of loans issued by different institutions and banks which provide direct financial assistance. The broad areas in which the fund-based financial service providers operate are;

- Primary market and secondary market activities and operations.
- FOREX market services.
- Financial innovation and financial engineering services.
- Specialized financial services.

The following are the different examples of fund-based service providers;

I. **Factoring and Forfaiting:** Trade receivables are sold to a factor—usually a bank—in exchange for prompt cash payment. This process is known as factoring. Forfaiting, on the other hand, is a type of export finance in which the exporter sells to forfeiture the right to trade receivables in exchange for immediate cash.

II. **Consumer loans and credit:** Consumer loans and credit are financial instruments that allow individuals to borrow money for various purposes, such as purchasing goods, covering expenses, or investing in opportunities. These financial products are crucial for individuals' financial flexibility and can be obtained from banks, credit unions, online lenders, and other financial institutions.

III. **Bill Discounting:**Bill discounting, also known as invoice discounting or factoring, is a financial practice in which a business owner sells its accounts receivable (invoices) to a third party at a discount. This practice allows the business to receive immediate cash for its outstanding invoices before the customers have actually paid. Bill discounting is commonly used by businesses to improve cash flow, manage working capital, and meet short-term financial obligations.

IV. **Hire Purchase:** Hire purchase (HP) is a financial arrangement that allows individuals or businesses to acquire assets, such as vehicles, machinery, or equipment, without having to pay the full purchase price upfront. In a hire purchase agreement, the buyer pays for the asset in instalments over a fixed period. The ownership of the asset is transferred to the buyer after the final instalment is paid, making hire purchase a form of asset financing.

V. **Lease financing:** Lease financing is a financial arrangement where one party, the lessor, owns an asset and allows another party, the lessee, to use the asset for a specified period in exchange for regular payments. Lease financing is commonly used by businesses to acquire assets such as equipment, vehicles, machinery, and real estate without the need for significant upfront capital. There are several types of leases, each with its unique characteristics:

Operating Lease: An operating lease is a short-term lease arrangement where the lessor retains ownership of the asset. The lessee pays regular lease payments for using the asset but does not assume the risks and responsibilities associated with ownership. Operating leases are common for assets with a short lifespan and technology that quickly becomes obsolete. At the end of the lease term, the lessee typically has the option to return the asset, renew the lease, or purchase the asset at its fair market value.

Financial Lease (Capital Lease): A financial lease is a long-term lease arrangement where the lessee effectively assumes the risks and rewards of ownership. The lease term is often close to the useful life of the asset. The lessee makes regular lease payments and is usually responsible for the maintenance, insurance, and other costs associated with the asset. At the end of the financial lease term, the lessee typically has the option to purchase the asset at a nominal price. Financial leases are suitable for assets that have a long economic life and retain their value over time.

VI. **Insurance:** Insurance is a risk management tool that allows individuals, businesses, and organizations to transfer the financial burden of certain risks to an insurance company. In exchange for regular payments called premiums, the insurance company provides financial protection against potential losses, such as property damage, illness, accidents, or other unforeseen events. Insurance plays a crucial role in providing financial

security and promoting stability in various aspects of life. Here are the key components and types of insurance:

Key Components of Insurance:

Policyholder: The person or entity purchasing the insurance policy and paying premiums to the insurance company.

Insurer: The insurance company that provides the insurance coverage and assumes the financial risks outlined in the policy.

Premium: The regular payments made by the policyholder to the insurer in exchange for the insurance coverage.

Policy: The legal contract between the policyholder and the insurer, outlining the terms, conditions, coverage limits, and exclusions of the insurance arrangement.

Coverage: The specific risks and events for which the policyholder is protected under the insurance policy.

Types of Insurance:

Life Insurance: Provides a financial benefit to beneficiaries upon the death of the insured person. It can also include additional features such as investment components (as in the case of whole life insurance) or term life insurance, which covers a specific period.

Health Insurance: Covers medical expenses and treatments, providing financial support in case of illness or injury. Health insurance policies vary widely, covering different types of medical services, prescription drugs, and procedures.

Auto Insurance: Provides financial protection in case of accidents, theft, or damage to the insured vehicle. It also covers liability, which pays for damages and injuries caused to others in an accident.

Homeowners/Renters Insurance: Protects against property damage, theft, or liability for homeowners. Renters insurance provides similar coverage for individuals renting a home or apartment.

Property Insurance: Covers damage or loss of property, including commercial buildings, equipment, inventory, and other assets. Property insurance can protect against risks such as fire, natural disasters, or vandalism.

Liability Insurance: Protects individuals and businesses from legal claims and financial losses resulting from negligence, injury, or property damage to others.

Travel Insurance: Provides coverage for trip cancellations, medical emergencies, lost luggage, or other unexpected events while travelling.

Insurance is essential for managing risks and protecting against unforeseen events that could lead to significant financial losses. Policyholders must carefully read and understand the terms of their insurance policies to ensure they have adequate coverage for their specific needs. Insurance helps individuals and businesses navigate uncertainties, promoting financial stability and peace of mind.

VII. Venture Capital: Venture capital (VC) refers to a type of private equity financing provided to startups and small businesses by investors who believe in the long-term growth potential of these companies. Venture capitalists are professional groups or individuals who invest money in promising ventures in exchange for equity ownership, often taking an active role in the management and decision-making processes of the company.

Startup Funding Stages:

Seed Stage: At this stage, startups receive initial funding to develop their business idea, conduct market research, and create a prototype. Seed funding often comes from the founders' savings, family, friends, or angel investors.

Early Stage: Once the startup has a viable product or service, it seeks additional funding to refine the product, expand operations, and reach a larger customer base. Early-stage funding is where venture capital investments become significant.

Expansion Stage: Also known as the growth stage, companies at this stage have a proven business model and customer base. Venture capital funding during the expansion stage helps businesses scale their operations and enter new markets.

Later Stage: In this stage, companies are well-established and profitable. Investors may provide capital for acquisitions, mergers, or further expansion.

Venture capital plays a vital role in fostering innovation, supporting entrepreneurship, and driving economic growth by providing funding and mentorship to high-potential startups. Entrepreneurs seeking venture capital must be prepared to demonstrate their business's potential for growth and scalability while understanding the terms and conditions associated with venture capital investments.

VIII. Housing Finance: Housing finance refers to the financial services provided to individuals and families to facilitate the purchase, construction, renovation, or refinancing of residential properties. Housing finance institutions, such as banks, mortgage companies, and housing finance corporations, offer various products and services tailored to meet the diverse housing needs of consumers.

Stop to Consider

India as a country is slowly adopting start ups and entrepreneurs. This is one of the important developments which is going to impact the country on a positive note. Discuss the recent start up initiatives undertaken by the present Government.

Check Your Progress

1) What are the different traditional financial services?
2) The regular payments made by the policyholder to the insurer in exchange for the insurance coverage are called?
3) In which stage of venture capital funding start ups receive initial funding to develop their business idea, conduct market research, and create a prototype?

b) Fee-based financial services: On the other side fee-based financing services provide services on the basis of non-fund-based activities. The direct lending of the fund is not involved under these kinds of services but the financing intermediaries play a middleman role by providing assurance and guarantee between the two parties involved. The financial intermediaries charges fee to provide certain assistance such as commission on DD(demand

draft), letter of credit/ guarantee, management of pre-issue and post-issue related to the capital issue, and assisting in the process of getting all government and others clearness. The major fee-based financial services are as follow:

a) **Issue Management:** Issue management, in the context of finance and securities, refers to the process of overseeing and facilitating the issuance of new securities by companies or governments. This process involves various tasks and responsibilities to ensure the successful launch of securities in the financial market.

b) **Corporate Advisory Services:** Corporate advisory services involve providing expert advice and assistance to businesses on various financial, strategic, and operational matters. These services are typically offered by specialized consulting firms, investment banks, or financial institutions. Corporate advisory services aim to enhance a company's overall performance, improve financial outcomes, and achieve strategic objectives

c) **Credit Rating:** Credit rating is a significant financial tool that evaluates the creditworthiness of individuals, corporations, or countries. It provides a systematic assessment of their ability to meet financial obligations, repay debts, and manage financial risks. Credit rating agencies, such as Moody's, Standard & Poor's, and Fitch Ratings, play a pivotal role in the global financial system by offering valuable insights to investors, creditors, and governments. This essay explores the importance of credit ratings, their methodologies, impact on financial markets, and the challenges associated with them. Credit ratings serve as an essential gauge for investors and creditors, enabling them to make informed decisions about lending money or investing in bonds and securities. These ratings influence the interest rates borrowers pay, affecting the cost of capital for businesses and governments. A high credit rating implies a lower risk of default, making it easier and cheaper for entities to raise funds. Conversely, a low credit rating suggests a higher risk, potentially leading to increased borrowing costs and decreased access to capital.

   Credit Rating Methodologies

Credit rating agencies employ rigorous methodologies to assess credit risk. They analyze financial statements, market conditions, economic indicators, management quality, and other relevant factors. Agencies

assign letter grades or symbols, such as AAA, AA, A, BBB, etc., indicating the creditworthiness of the rated entity. Each grade signifies a specific level of credit risk and guides investors in their decision-making processes.

d) **Mutual Funds:** A mutual fund is a trust that combines the savings of several investors with similar objectives. As a result, it provides the average person with the chance to invest at a reasonable price in a professionally managed, diverse basket of securities. Put another way, mutual funds use the assistance of qualified managers to invest the money they receive from investors in capital market instruments like stocks, bonds, and other securities. A mutual fund is typically a long-term, high-risk investment. Naturally, the open-ended nature of mutual funds guarantees that you will always have access to funds at short notice. In other words, the scheme purchases securities on behalf of unit holders keeps track of interest and dividend payments from these securities, and sells the securities when you need cash. Investors may purchase units of the scheme on the stock exchanges where they are listed, or they may choose to purchase or sell them at the time of the initial public offering. Afterward, investors may choose to invest in closed-ended funds. The option to sell back the units to the mutual fund through a recurring repurchase at NAV-related prices exists in certain schemes.

e) **Asset Securitisation:** Asset securitization is a financial practice that transforms illiquid assets into tradable securities. It involves pooling various financial assets, such as mortgages, auto loans, or credit card debts, and repackaging them into securities that can be sold to investors. This innovative financial technique enhances liquidity in the market, diversifies risks, and has far-reaching implications for both the financial industry and the broader economy. This essay delves into the concept of asset securitization, its benefits, risks, and its impact on the financial landscape.

Check Your Progress

1) A mutual fund is a ………… that combines the savings of several investors with similar objectives.

2) …………………involve providing expert advice and assistance to businesses on various financial, strategic, and operational matters.

1.7.2 Modern Financial Services: Modern Financial Services are all those financial services that have evolved over the years. They cater to new and ever evolving requirements of clients. Some of the modern financial services include but is not limited to the following;

- **Advisory Role in Corporate Restructuring:** An advisory role in corporate restructuring involves providing expert guidance and recommendations to organizations undergoing significant changes in their structure, operations, or financial situations. Corporate restructuring can encompass various activities, such as mergers and acquisitions, divestitures, joint ventures, debt restructuring, and organizational redesign.
- **Trusteeship for Debenture holders:** Trusteeship for debenture holders involves the appointment of a trustee by a company issuing debentures to safeguard the interests of the debenture holders. Debentures are long-term debt instruments that companies use to raise funds from the public. When a company issues debentures, it creates a trust deed that outlines the terms and conditions of the debentures and appoints a trustee to act on behalf of the debenture holders.
- **Rehabilitating and Reconstruction of Sick units:** Rehabilitating and reconstructing sick units (also known as sick industries or financially distressed companies) is a multifaceted process aimed at reviving and restoring the financial health and operational efficiency of struggling businesses.
- **Portfolio Management Service:**Portfolio Management Service (PMS) is a professional service offered by portfolio managers to manage the investments of high-net-worth individuals (HNIs) or institutions. In PMS, the portfolio manager invests on behalf of the

client, based on the client's investment objectives, risk tolerance, and financial goals.

- o **Risk Management Service:** Risk Management Services (RMS) refer to the process of identifying, assessing, and prioritizing potential risks in an organization's operations, projects, or investments. These services are designed to help businesses mitigate and manage risks effectively, ensuring the protection of assets, reputation, and financial stability.
- o **Safe Custody of Securities:** Safe custody of securities refers to the secure storage and management of financial instruments, such as stocks, bonds, mutual fund units, and other valuable documents, on behalf of investors or clients. Financial institutions, including banks and brokerage firms, typically offer safe custody services to individuals, corporations, and institutions.
- o **Project Counselling:** Safe custody of securities refers to the secure storage and management of financial instruments, such as stocks, bonds, mutual fund units, and other valuable documents, on behalf of investors or clients. Financial institutions, including banks and brokerage firms, typically offer safe custody services to individuals, corporations, and institutions.

2.8 Evolution of Financial Services in India

It depends on the efficiency of the overall financial system which includes financial institutions, markets, instruments and financial services. The financial services sector is booming in India and it has passed through various stages which can be categorised under the Initial Phase (1960-80), second phase (1980-90) and third phase (1990 onwards) The efficiency of the recent financial system based comprehensively on the efficiency of financial services provided by financial intermediaries. The Indian financial services industry has gone through the most difficult period and yet remains solid among world economies. To have a profound impact on the far-reaching changes to the Indian economy as liberalization, the new face of this industry is evolving into a strong, transparent and robust system. In recent years, financial markets have witnessed a significant expansion and deepening of service baskets with the introduction of several new instruments and products in the area of banking operations, financial institutions, insurance companies

and capital markets. The sector has been opened to new private operators, including foreign companies that adopt international best practices and modern technology to provide a more sophisticated range of financial services to corporate, retail and institutional clients. Regulators in the financial sector have also been visionaries to ensure that the new regulations and guidelines are in line with global standards. These developments have given a strong impetus to the development and modernization of the financial services sector in India.

2.9 Recent Trends in the Financial Service Sector in India.

The financial services sector in India has grown significantly during the last many years. From this trend, it can be anticipated that this momentum will continue. The private wealth management sector in India has enormous promise. By 2025, there should be 6.11 lakh HNWIs in India. In fact, as a result, by 2028, India's private wealth market will rank fourth in the world. By 2025, the insurance market in India is projected to grow to a value of USD 250 billion. This would also present India with the chance to receive an extra US$ 78 billion in life insurance premiums between 2020 and 2030.By 2025, the Association of Mutual Funds in India (AMFI) hopes to have more than three times as many investor accounts—130 million—and nearly five times as much AUM, or US$ 1.15 trillion (Rs. 95 lakh crore).This expansion is anticipated to be further fueled in several industries by India's Fintech industry. The mobile wallet market in India is predicted to expand at a 150% Compound Annual Growth Rate (CAGR) to reach US$ 4.4 billion by 2022, and during that time, mobile wallet transactions are expected to reach US$ 388.8 billion (Rs. 32 trillion).Investors are flooding the Indian stock market, which Goldman Sachs predicts could surpass the UK and grow to become the world's fifth-largest stock market by 2024, with a market capitalization of over US$ 5 trillion.

2.10 Summing Up

In conclusion, financial services play a pivotal role in shaping the economic landscape and improving the quality of life for individuals and businesses alike. The diverse array of services offered, ranging from banking and investments to insurance and financial planning, empowers people to manage their resources, plan for the future, and mitigate risks effectively. Furthermore,

the continuous advancements in technology have made financial services more accessible, convenient, and inclusive than ever before.As we move forward, it is essential to recognize the significance of responsible financial management and education. Access to reliable and transparent financial services can uplift communities, promote economic growth, and foster financial stability. By embracing innovation, ensuring financial literacy, and upholding ethical standards, financial service providers can contribute significantly to building a more prosperous and financially secure future for individuals, families, and businesses worldwide.

2.11 Model Questions

1. Give an explanation of "Financial Services" and the most recent changes in this field.
2. Discuss the significance of the financial services sector in detail.
3. Explain the fund-based and fee-based financial services.
4. What are the characteristics of financial services?
5. Explain the major functions of financial services

2.12 References and Suggested Readings

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Unit-3
Regulating Framework for Financial System and its Importance

Unit Structure:

3.1 Introduction

3.2 Objectives

3.3 Regulatory Framework and Its importance

3.4 Regulatory Framework of Indian Financial System

3.4.1 Reserve Bank of India

3.3.2 The Securities and Exchange Board of India (SEBI)

3.3.3 The Insurance Regulatory and Development Authority of India (IRDAI)

3.3.4 The Pension Fund Regulatory and Development Authority (PFRDA)

3.3.5 Forward Market Commission of India

3.5 Other regulatory bodies.

3.5.1 NABARD

3.5.2 SIDBI

3.5.3 The National Housing Bank (NHB) SIDBI

3.6 Future Prospects and Challenges

3.7 Summing Up

3.9 Model Questions

3.8 References and Suggested Readings

3.1 Introduction

The financial system of India is a complex and diverse ecosystem that serves as a fundamental pillar for the nation's economic progress and advancement. The system encompasses a range of businesses, including as banks, non-banking financial corporation's (NBFCs), insurance companies, mutual funds, stock exchanges, and other similar entities. In order to guarantee the stability, integrity, and efficiency of this complex network, it is imperative to establish a comprehensive and resilient regulatory framework.

3.2 Objectives

After going through this unit you will be able to-

- *understand* the meaning of Regulatory framework,
- *understand* the need and importance of financial regulation,
- *explain* the regulatory framework of Indian Financial System.

3.3 Regulatory Framework and Its Importance

Regulatory Framework is a mechanism that creates legal obligation or frames certain regulations to be followed by the stakeholders of the particular system. This regulatory framework may consist of public authorities or government agencies. Regulatory framework for the financial system implies the various rules, regulations, laws, by-laws and amendments etc., framed by the regulatory bodies and government agencies working in the area of financial system.

3.4 Regulatory Framework of Indian Financial System

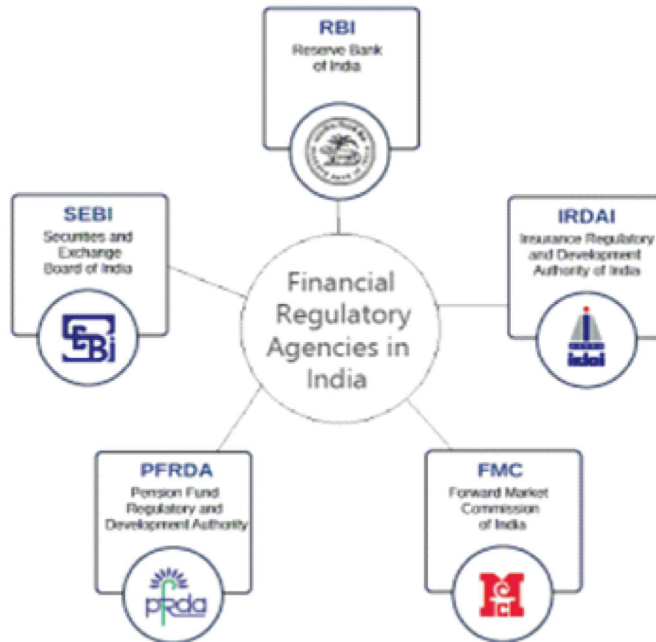
The financial system in India is regulated by independent regulators in the field of banking, insurance, capital market, and commodity market and pension funds. However, Government of India plays a significant role in controlling the financial system in India and influences the roles of the regulators at least to some extent. The Regulatory Framework of the Indian Financial system consist of the following five major financial regulatory bodies and some quasi regulatory bodies as mentioned below:

A) Statutory bodies via parliamentary enactments:

1) Reserve Bank of India
2) Securities and Exchange Board of India
3) Insurance Regulatory and Development Authority

B) Part of Ministries of the Government of India.

4) Forward Market Commission of India (under the Ministry of Consumer Affairs, Food and Public Distribution, Govt of India)
5) PFRDA (under the Ministry of Finance)



Sources : www.testbook.com

Apart from the above main regulators, there are various *quasi regulatory agencies* such as NABARD, SIDBI and NHB

Lets us try to understand the role played by each of the regulatory bodies in regulating the financial system.

3.4.1 Reserve Bank of India

The Reserve Bank of India is the regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country's banking and financial system functions. The main objective of RBI as regulator and supervisor is to maintain public confidence in the system, protect depositor's interest and provide cost effective banking service to the public. The Payment and Settlement System Act 2007 gives the RBI the authority for the supervision and regulation of payment and settlement system in the country for the development of safe, secure and efficient payment and settlement mechanism. RBI also plays the role of regulator of credit through its quantitative and qualitative controls measures, which are especially used in the money market. By exercising such measure the RBI influences the volume of credit created by banks in India. As per the power conferred by FEMA 1999, RBI regulates the foreign exchange market by

issuing licence to banks and money dealers. The primary function of RBI includes:

i) Monetary Policy: Monetary policy refers to the actions and decisions undertaken by a central bank or monetary authority to manage and control the money supply and interest. The Reserve Bank of India (RBI) is responsible for the formulation and implementation of monetary policies aimed at ensuring price stability and fostering economic growth. This is accomplished through several processes such as the repo rate, reverse repo rate, and open market operations.

ii) Banking regulation: The Reserve Bank of India (RBI) assumes the responsibility of overseeing and controlling banks and financial institutions to guarantee their robustness and stability. The regulatory body is responsible for the issuance of licenses, establishment of prudential rules, and implementation of inspections to uphold the integrity of the banking system.

iii) Currency management: The Reserve Bank of India (RBI) assumes the role of the official authority responsible for the issuance and management of the Indian Rupee. Its primary functions encompass the oversight of currency supply, preservation of its authenticity, and facilitation of its widespread acceptance.

iv) Payment systems: Payment systems refer to the various methods and mechanisms used to facilitate the transfer of funds between individuals, businesses, and other entities. The Reserve Bank of India (RBI) is responsible for the supervision and regulation of payment and settlement systems to ensure the efficient execution of financial transactions. This includes the oversight of key systems such as Real-Time Gross Settlement (RTGS) and National Electronic Funds Transfer (NEFT), which play a crucial role in facilitating seamless monetary transfers.

v) Foreign exchange management: Foreign exchange control refers to the regulation and supervision of the flow of currency across national borders. It involves the use of various measures by governments or central banks to manage and monitor. The Reserve Bank of India (RBI) is responsible for the management of India's foreign exchange reserves and the regulation of foreign exchange transactions in order to ensure the stability of the country's external sector.

Stop to Consider

The regulatory framework of Indian Financial System is much robust and dynamic as compared to the regulatory framework of various undeveloped and developing countries. Please try to get an idea about the regulatory framework of the financial system of Bhutan and Bangladesh.

3.3.2 The Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India (SEBI) is a regulatory body responsible for overseeing and regulating the securities market in India. SEBI was established in the year 1992 as a statutory body and was empowered to regulate the capital market and protect the investors' interest. SEBI performs the following functions:

i) Regulates the capital market: The Securities and Exchange Board of India (SEBI) is responsible for overseeing and regulating the functioning of capital markets in order to uphold principles of equity, transparency, and safeguard the interests of investors. The primary functions of this entity encompass the surveillance of stock exchanges, the maintenance of market integrity, and the enforcement of regulatory measures.

ii) Supervision of Market Participants: SEBI is responsible for registering and supervising entities such as stock exchanges, brokers, merchant bankers, and mutual funds. This ensures that these entities comply with regulatory standards and conduct their activities in a transparent manner.

iii) Ensures compliance with various regulations: The Securities and Exchange Board of India (SEBI) have the requisite jurisdiction to uphold securities legislation and regulations, conduct inquiries into market manipulation, insider trading, and fraudulent practices, with the objective of preserving the integrity of the market.

iv) Educates investors and protects their interest: The Securities and Exchange Board of India (SEBI) places significant importance on the promotion of investor awareness and education to encourage market participation and protect the interests of investors.

Moreover, SEBI conducts inspection, inquiries and audits of stock exchanges, intermediaries and self regulating organisations and takes suitable remedial measures wherever necessary. Further, it penalise those who

undertake fraudulent and unfair trade practice. The role of the Securities and Exchange Board of India (SEBI) in safe-guarding the integrity and transparency of capital markets is very crucial.

3.3.3 The Insurance Regulatory and Development Authority of India (IRDAI)

The Insurance Regulatory and Development Authority of India (IRDAI), established in 1999 is a regulatory body responsible for overseeing and promoting the development of the insurance sector in India. The main motive of IRDAI is to protect the interest of the policy holders, to regulate, promote and ensure orderly growth of the insurance industry.

i) Regulation and Licensing: IRDAI licenses insurance companies and oversees their activities, ensuring that prudential standards and solvency criteria are met.

ii) Product Certification: The regulator approves insurance products to ensure that they meet regulatory standards and protect the interests of policyholders.

iii) Policyholder Defence: IRDAI protects policyholders' interests by ensuring that insurance companies fulfil their agreements and treat policyholders properly.

iv) Market Expansion: By encouraging innovation and competition, IRDAI plays a critical role in promoting the development and expansion of the insurance business.

The insurance business is critical for risk management and long-term financial planning, and IRDAI regulation assures its stability and efficacy.

3.3.4 The Pension Fund Regulatory and Development Authority (PFRDA)

The Pension Fund Regulatory and Development Authority (PFRDA),established in 2003 is an organization responsible for the regulation and development of pension funds. The Pension Fund Regulatory and Development Authority (PFRDA) is the regulatory body entrusted with the responsibility of overseeing and fostering the development of the pension sector in India. The main functions of PFRDA are:

i) Regulating the National Pension System (NPS): The Pension Fund Regulatory and Development Authority (PFRDA) is responsible for the regulation and administration of the National Pension System (NPS) for both individual and corporate participants, with the aim of promoting long-term retirement planning.

ii) Management of the Pension Fund: The Pension Fund Regulatory and Development Authority (PFRDA) is responsible for the oversight of pension fund managers, with the primary objective of guaranteeing the implementation of sensible investment methods and effective risk management strategies. This regulatory body aims to safeguard the interests of pension subscribers.

iii) Educating the Subscribers: The primary objective of the Pension Fund Regulatory and Development Authority (PFRDA) is to foster pension awareness and education among individuals, with the aim of motivating them to engage in retirement planning and make well-informed decisions on their pension arrangements.

The pension industry plays a vital role in ensuring financial stability during an individual's post-retirement phase, and the PFRDA (Pension Fund Regulatory and Development Authority) plays a pivotal role in facilitating its growth and progress.

3.3.5 Forward Market Commission of India

Forward Market Commission of India is a regulatory authority for commodity future markets in India. It was established in the year 1953.It comes under the Ministry of Consumer Affairs, Food and Public Distribution, Government of India. The following are the functions of the commission.

i) To advise the central government in respect of the recognition or the withdrawal of recognition from any association.

ii) To advise the central government in respect of issues arising out of the administration of the Forward Contracts (Regulation) Act 1952.

iii) To keep the forward markets under observation and takes such action in relation to them, as it may consider necessary, in exercise of the powers assigned to it under the Act.

iv) To collect and publish information regarding the trading conditions in respect of goods to which any of the provisions of the Act is made

applicable, including information regarding supply, demand and prices, and to submit to the central government, periodical reports on the working of forward markets relating to such goods.

v) To make recommendations to improve the organisation and working of forward markets;

vi) To undertake the inspection of accounts and other documents of any recognised association, registered association or any member of such association whenever it considers it necessary.

Check Your Progress

1. How does the Securities and Exchange Board of India (SEBI) contribute to ensuring fairness and transparency in India's capital markets?
   a) By providing loans to stock market participants.
   b) By regulating banks' interest rates.
   c) By enforcing regulations, monitoring stock exchanges, and promoting investor education.
   d) By managing India's foreign exchange reserves.
2. What role does the Insurance Regulatory and Development Authority of India (IRDAI) play in safeguarding policyholders' interests in the insurance sector?
   a) Approving insurance products for marketing.
   b) Promoting foreign insurance companies.
   c) Safeguarding policyholders' interests, ensuring fair treatment, and regulating insurance companies.
   d) Regulating the capital markets.
3. What are the key functions of the Pension Fund Regulatory and Development Authority (PFRDA) in regulating the pension sector?
   a) Regulating mutual funds.
   b) Promoting foreign investment in pensions.
   c) Regulating agricultural finance.
   d) Regulating and administering the National Pension System (NPS).

3.5 Other Regulatory Bodies

In addition to the above mentioned basic regulatory bodies, India is home to specialized organizations that play a crucial role in promoting financial inclusion and sector-specific growth. These institutions work in collaboration with the principal regulators to accomplish diverse developmental goals. Some other regulatory bodies are:

3.5.1 NABARD

The National Bank for Agriculture and Rural Development (NABARD) is a financial institution that operates at the national level and focuses on providing support and development for agriculture and rural areas. The National Bank for Agriculture and Rural Development (NABARD) was created in the year 1982 with the primary aim of facilitating and fostering rural development and agricultural activities. The program offers financial and developmental assistance to those engaged in agriculture, rural entrepreneurship, and cooperative organizations. The National Bank for Agriculture and Rural Development (NABARD) assumes a crucial role in the facilitation of loan flow to the agricultural sector and the provision of support for the development of rural infrastructure.

3.5.2 SIDBI

The Small Industries Development Bank of India (SIDBI) is a financial institution focusing on developing and supporting small industries in India. The Small Industries Development Bank of India (SIDBI) is committed to the advancement and growth of micro, small, and medium-sized firms (MSMEs) within the Indian context. The organization provides a diverse array of financial and non-financial services to micro, small, and medium enterprises (MSMEs), encompassing loan provisions, venture capital investments, and technical support. The endeavours of SIDBI make a substantial contribution to the advancement and enduring viability of this pivotal industry.

3.5.3 The National Housing Bank (NHB)

The National Housing Bank (NHB) is a financial institution operating at the national level. The National Housing Bank (NHB) was founded with the

purpose of overseeing and advancing the housing finance industry within the Indian context. The provision of liquidity support to housing finance companies (HFCs) and the promotion of affordable housing initiatives are of utmost importance. The activities of the National Housing Bank (NHB) are in accordance with the government's objective of achieving "Housing for All" and promoting the growth of the real estate industry.

Check Your Progress

1. How do institutions like the National Bank for Agriculture and Rural Development (NABARD) contribute to rural development and agriculture in India?
   a) By providing financial support to urban entrepreneurs.
   b) By regulating rural credit cooperatives.
   c) By promoting rural development, offering financial support to farmers, and supporting rural infrastructure development.
   d) By regulating housing finance companies.
2. What role does the Small Industries Development Bank of India (SIDBI) play in supporting micro, small, and medium-sized enterprises (MSMEs)?
   a) It promotes foreign direct investment in MSMEs.
   b) It provides loans to large industries.
   c) It offers financial and non-financial services to MSMEs, including loans, venture capital, and technical assistance.
   d) It regulates stock exchanges.
3. How does the National Housing Bank (NHB) contribute to promoting housing finance and real estate development in India?
   a) By providing loans to housing finance companies.
   b) By promoting the development of luxury housing.
   c) By regulating housing prices.
   d) By providing liquidity support to housing finance companies (HFCs) and fostering affordable housing initiatives.

3.6 Future Prospects and Challenges

Despite progress in developing a comprehensive regulatory framework for the Indian financial industry, significant difficulties and opportunities remain. These are:

i) Technological Progress: Rapid technical breakthroughs are occurring in the financial sector, including the rise of fintech companies, digital banking, and block chain-based solutions. While these advances increase efficiency and convenience, they also raise regulatory concerns about data security, consumer protection, and cyber dangers. To keep up with these advancements while preserving the safety and security of financial transactions, regulators must react quickly.

ii) Regulatory Harmonization: With the rising convergence of financial services, authorities must work together to regulate conglomerates that operate across numerous areas. Financial conglomerates, which provide banking, insurance, and securities services under one roof, require coordinated regulation to successfully limit systemic risks.

iii) Financial Inclusion: Financial inclusion is still a high priority. Regulators must guarantee that their rules and laws make financial services available to underrepresented and underprivileged communities. Initiatives such as the Jan Dhan Yojana and Aadhar-enabled payment systems have made great progress in this area, but more work remains to be done.

iv) Sustainable Finance: The global emphasis on responsible finance and investment is expanding. In India, regulators have begun to include environmental, social, and governance (ESG) considerations into financial decision-making. Incorporating ESG principles into legislative frameworks will be critical to encouraging responsible and sustainable finance in the country.

Check Your Progress

1. What are the key challenges posed by technological advancements in the financial sector, and how can regulators address them?

   a) There are no challenges associated with technological advancements in the financial sector.

   b) Challenges include data security, consumer protection, and cyber threats. Regulators can address them by ignoring technological advancements.

c) Challenges include data security, consumer protection, and cyber threats. Regulators can address them by adapting swiftly and ensuring safety and security.

d) Challenges include promoting speculative trading and unregulated financial activities.

2. How can regulatory convergence be achieved to effectively oversee financial conglomerates operating across multiple domains?

a) By having separate regulators for each financial domain.

b) By not regulating financial conglomerates.

c) By ensuring coordinated regulation among different financial regulators.

d) By promoting competition among regulators.

3. What initiatives are needed to further promote financial inclusion in India, and how can regulators contribute to these efforts?

a) There is no need for financial inclusion in India.

b) Initiatives may include promoting access to financial services for underserved populations, and regulators can contribute by ignoring these initiatives.

c) Initiatives may include promoting access to financial services for underserved populations, and regulators can contribute by ensuring that policies and regulations facilitate financial inclusion.

d) Initiatives may include promoting speculative trading among underserved populations.

3.7 Summing Up

A stable and efficient financial system relies heavily on the presence of a robust regulatory framework. The financial regulatory bodies in India, such as the Reserve Bank of India, Securities and Exchange Board of India, Insurance Regulatory and Development Authority of India, and Pension Fund Regulatory and Development Authority, have undergone significant transformations in response to the evolving dynamics of the financial industry.

As India progresses in its pursuit of economic growth and development, it is imperative to maintain the adaptability, innovation, and responsiveness of its regulatory framework to address growing difficulties and capitalize on possibilities. The future of the Indian financial system would be significantly influenced by the combined efforts of regulators and cooperative and developmental institutions like as NABARD, SIDBI, and NHB.

3.8 Model Questions

Short Answer Questions:

1. What was the primary objective behind the establishment of the Reserve Bank of India (RBI) in 1935?
2. Explain the significance of the Banking Regulation Act of 1949 in India's financial regulatory framework.
3. Name one key function of the Securities and Exchange Board of India (SEBI) and how it contributes to investor protection.
4. What role does the Insurance Regulatory and Development Authority of India (IRDAI) play in the insurance sector, and how does it safeguard policyholders?
5. Briefly describe the primary responsibilities of the Pension Fund Regulatory and Development Authority (PFRDA) in India's pension sector.

Long Answer Questions:

1. Trace the historical evolution of financial regulation in India from the colonial era to post-independence, highlighting significant milestones and changes in the regulatory landscape.
2. Discuss the impact of economic liberalization in the 1990s on India's financial sector, including the emergence of non-banking financial companies (NBFCs) and the diversification of financial services.
3. Provide an in-depth analysis of the functions and responsibilities of the Reserve Bank of India (RBI) in the Indian financial system, emphasizing its role in monetary policy and banking regulation.
4. Explain the concept of financial inclusion and outline the initiatives needed to promote it in India. Discuss how regulators can contribute to these efforts.

5. Explore the challenges and opportunities presented by technological advancements in the financial sector. Discuss the role of regulators in addressing issues such as data security, consumer protection, and cyber threats while fostering innovation.

3.9 References and Suggested Readings

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