CHAPTER

2

ORGANIZATIONAL STRUCTURE OF THE INDIAN FINANCIAL SYSTEM

INTRODUCTION

The forces of change unleashed in the Indian economy over the last decade have transformed the opening environment across the entire spectrum of businesses. This coincided with rapid developments in technology that created both an opportunity and a challenge for businesses worldwide — the opportunity to innovate in product offerings to customers and improve operating efficiency, and the challenge of keeping pace with change and gaining first-mover advantage. These two developments catalysed significant shifts in the structure of the Indian economy, perhaps the most visible and far-reaching of which was the increased share of the services sector in the economy.

The liberalisation of the financial sector, which formed a key part of the overall liberalisation process, blurred the distinction between various financial intermediaries and promoted greater efficiency and competitiveness in the financial markets. The structure of the financial markets itself began to change — with the growth of the debt capital markets and the entry of new market participants like mutual funds, disintermediation gradually set in. This started the process of evolution of the financial intermediary into a provider of services in addition to an originator of credit.

THE STRUCTURE OF THE FINANCIAL SYSTEM

The financial system consists of many institutions, instruments, and markets. Financial institutions range from pawnshops and moneylenders to banks, pension funds, insurance companies, brokerage houses, investment trusts, and stock exchanges. Financial instruments range from the common — coins, currency notes, and checks; mortgages, corporate bills, bonds, and stocks — to the more exotic — futures and swaps of high finance. Markets for these instruments may be organized formally (as in stock or bond exchanges with centralized trading floors) or informally (as in over-the-counter or curb markets). For analytical purposes, the system can be divided into users of financial services and providers.

USERS OF FINANCIAL SERVICES

Financial institutions sell their services to households, businesses and government.

The household sector includes small mainly unregulated firms and individuals. Their main financial needs are for payment of services, saving and small credit. They seek convenience, liquidity and security.

Businesses have more complicated financial needs. It needs short-term credit to finance inventories and long-term funds to finance capital expansion.

All governments use payment services. In most developing countries, governments, like businesses, are net borrowers, and they use the financial system as a source of funding for current and capital spending. In industrial countries, government deficits are financed mainly by selling securities to the public. In developing countries they are usually financed by borrowing from banks. Governments have also used the financial system to serve development or other goals.

PROVIDERS OF FINANCIAL SERVICES

Different financial institutions provide services that are both complementary to and competitive with each other. Deposit institutions offer payment and liquid deposit facilities, and contractual savings institutions provide illiquid savings opportunities that cater to the longer-term needs of customers. Collective investment institutions offer small investors the benefits of professional management and low-cost risk diversification, encouraging them to diversify their savings into marketable securities. On the lending side, commercial banks have traditionally provided working capital and trade finance, but longer-term lending is gaining with the spread of universal banking. Factoring companies provide long-term investment finance.

Money and capital markets provide investment instruments appropriate for contractual savings and collective investment institutions, whose services to the saving public are thereby improved. The efficient functioning of financial markets also depends on institutions that lend and borrow little on their own account: investment banks, securities brokers, and credit rating agencies. Commercial banks also improve the working of financial markets by providing credit and payment facilities to market markers and other market participants.

Different financial institutions and markets compete for a limited pool of savings by offering different instruments. Money and capital markets increase competition between suppliers. Money markets give merchant banks, or commercial banks with limited branch networks, greater access to funds. Because such banks specialize in lending to larger corporations, the corporate loan market may be highly competitive, even though few large domestic banks may continue to dominate the retail deposit market.

Money markets also provide large corporations and non-bank financial institutions with efficient short-term instruments for investing their liquid funds and thus compete directly with commercial banks' traditional deposit facilities. They also enable large corporation to issue short-term securities in the form of commercial paper and thus further reduce the market power that large banks may have in the domestic banking sector. Finally, capital markets enable contractual savings and collective investment institutions to play a more active role in the financial system.

The complementary and competitive interaction of financial institutions has policy implications. To promote an efficient financial system there must be competition, but the system must also offer an array of services. Rather than restrict the growth and diversification of the main banking groups, governments in the greater competition by encouraging money and capital markets, specialized credit institutions (such as leasing and factoring companies), and contractual

savings and collective investment institutions. Economies too small to support such specialized institutions can spur competition by allowing economic agents to buy.

THE STRUCTURE OF THE FINANCIAL SYSTEM IN INDIA

The Indian financial system is broadly classified into two broad groups:

(*i*) organised sector and (*ii*) unorganised sector.

The financial system is also divided into users of financial services and providers.

Financial institutions sell their services to households, businesses and government. They are the users of the financial services. The boundaries between these sectors are not always clear cut.

In the case of providers of financial services, although financial systems differ from country to country, there are many similarities.

(*i*) Central bank (*ii*) Banks (*iii*) Financial institutions (*iv*) Money and capital markets and (*v*) Informal financial enterprises.

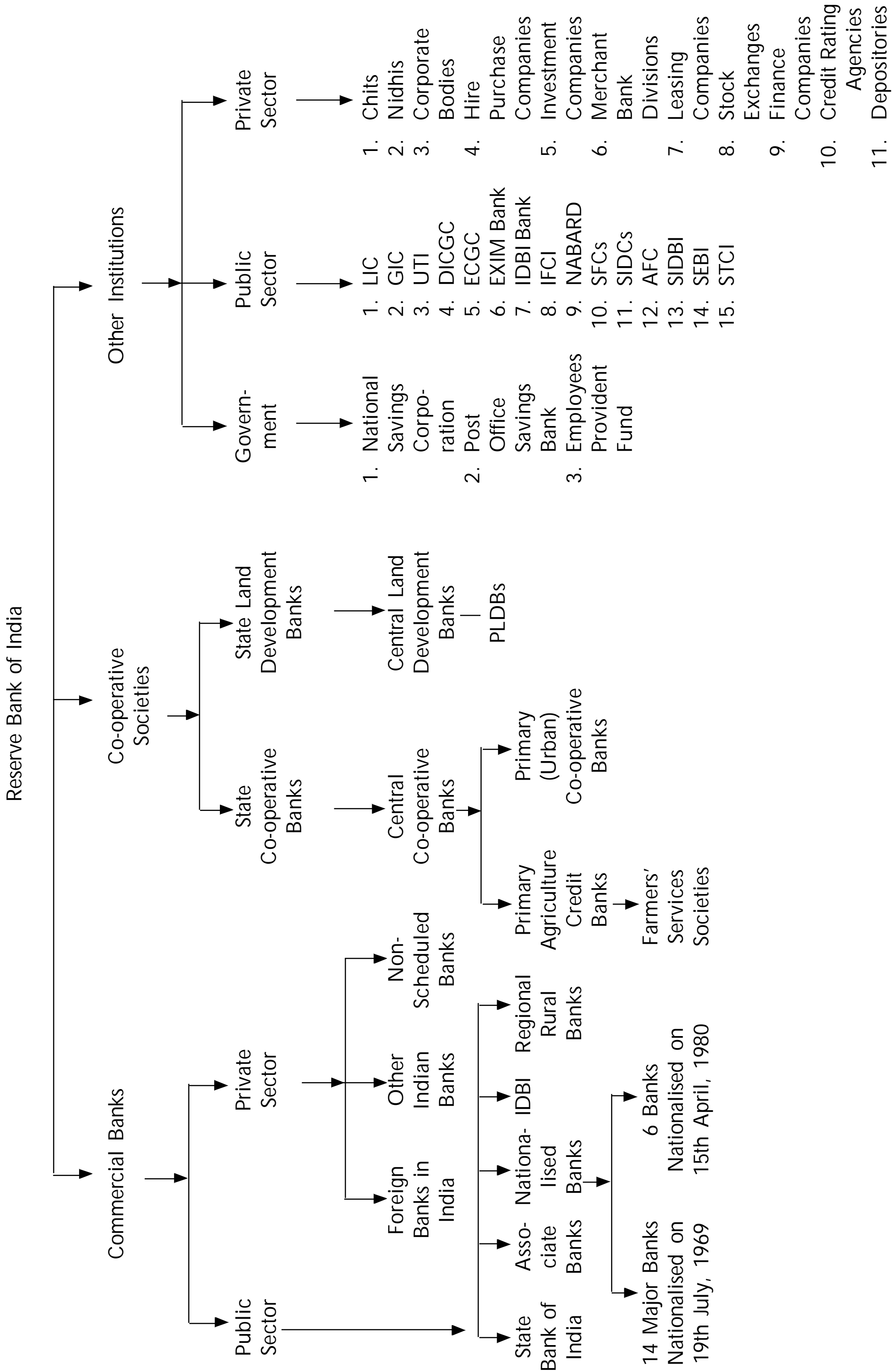
ORGANISED INDIAN FINANCIAL SYSTEM

The organised financial system comprises of an impressive network of banks, other financial and investment institutions and a range of financial instruments, which together function in fairly developed capital and money markets. Short-term funds are mainly provided by the commercial and co-operative banking structure. Nine-tenth of such banking business is managed by twenty-eight leading banks which are in the public sector. In addition to commercial banks, there is the network of co-operative banks and land development banks at state, district and block levels. With around two-third share in the total assets in the financial system, banks play an important role. Of late, Indian banks have also diversified into areas such as merchant banking, mutual funds, leasing and factoring.

The organised financial system comprises the following sub-systems:

1. Banking system
2. Co-operative system
3. Development Banking system
   (*i*) Public sector
   (*ii*) Private sector
4. Money markets and
5. Financial companies/institutions.
6. Microfinance institutions

Over the years, the structure of financial institutions in India has developed and become broadbased. The system has developed in three areas — state, co-operative and private. Rural and urban areas are well served by the co-operative sector as well as by corporate bodies with national status. There are more than 4,58,782 institutions channellising credit into the various areas of the economy. A broad structure of the financial system in India has been presented in the chart.



In addition, mutual funds, Insurance companies, capital market, venture, capital funds, as well regulatory authorities SEBI, IRDA credit Rating agencies are also part of the India Financial System.

UNORGANISED FINANCIAL SYSTEM

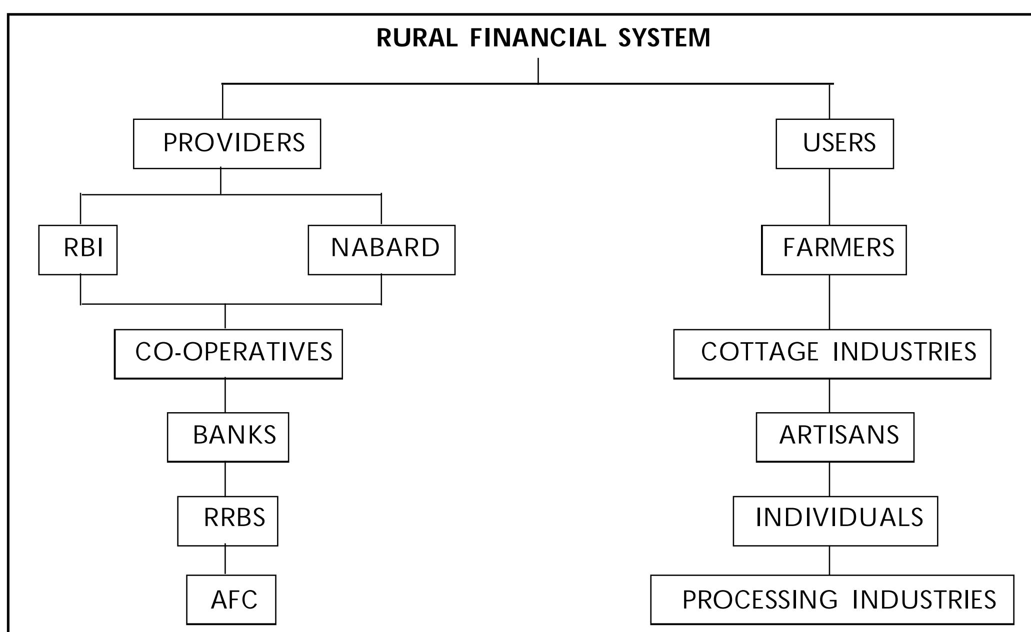
On the other hand, the unorganised financial system comprises of relatively less controlled moneylenders, indigenous bankers, lending pawnbrokers, landlords, traders, etc. This part of the financial system is not directly amenable to control by the Reserve Bank of India (RBI). There are a host of financial companies, investment companies, chit funds, etc., which are also not regulated by the RBI or the government in a systematic manner.

However, they are also governed by rules and regulations and are, therefore within the orbit of the monetary authorities.

RURAL FINANCIAL SYSTEM

Rural financial system has been evolved over a period of time from the year 1904, when the first Primary Agricultural Credit Society was organized, by accepting and implementing important recommendations of expert committees appointed by the Government of India/RBI from time-to-time. During the pre-reform period, more particularly, after the advent of the scientific and technological revolution in the sphere of agriculture, the Government of India and the RBI have evolved several new concepts, innovations and novel approaches, which the Rural Financial Institutions (RFIs) have responded very favourably by implementing them. These are as under:

- Adoption of multiagency approach comprising *(a)* short-term and long-term co-operative credit structure *(b)* nationalization of 20 commercial banks in two phases in 1969 and 1980, besides State Bank of India and its seven Associates, and *(c)* establishment of 196 Regional Rural Banks from the year 1975, thereby strengthening the supply side of credit to meet the emerging demand for credit of various sectors of rural economy/ poor households.



- Established Agricultural Refinance Corporation (1966)/Agricultural Refinance & Development Corporation (1978) which has now been reconstituted as National Bank for Agriculture and Rural Development (National Bank) from the year 1982 to play promotional, development, supervision, co-ordination and institution building role, augment the resource base of RFI through provision of finance and refinance to primary lending institutions on reasonably liberal terms and several other functions connected with the process of accelerating the pace for agriculture and rural development.
- Introduction of the Lead Bank Scheme in 1972 to provide banking facilities throughout the length and breadth of the country, mobilize financial resources and deploy credit through formulating district credit plans/annual action plans, co-ordinating with developmental agencies and monitoring the performance of RFIs at the level of block, district and State on a quarterly basis for harnessing the productive resources for economic development through provision of credit in each of the districts of the country.
- Adopting of the Service Area Approach (1989) to refine the credit planning exercise at village level, and improving the quality and productivity of lending at the level of individual branch of the RFIs.
- The Rural Infrastructural Development Fund (1995) created at the level of National Bank through mobilizing the shortfall in the deployment of 40% of net bank credit to priority sectors by commercial banks, to provide adequate and qualitative infrastructure for enhancing productivity of capital and labour invested in agriculture.

RESTRUCTURING NEEDED

Recent significant developments that have taken place affecting the RFIs such as, the implementation of financial/banking sector reforms, adoption of new agricultural policy, draft of the Tenth Five Year Plan (2002-07) and signing of the Agreement on Agriculture under WTO have presented tremendous opportunities to RFIs to help the country establish a very strong base of agriculture and rural development in this decade through playing proactive role of rural development banks, taking initiative and establishing effective coordination among various agencies. However, if experience of the working of these RFIs during the post-reform period were any guide, it is felt that there is most urgent need for restructuring the RFIs and reorienting the rural banking and credit policy framework so as to make them committed, capable and vibrant enough to perform the following herculean task during this decade.

- Enabling the country to achieve food security, minimizing incidence of rural poverty significantly and generating self-employment opportunities for millions of asset-less rural household under tiny/cottage/rural industries, services and business sectors thereby reducing pressure on land/farm sector.
- Improving productivity, productions and profitability of crop farming/horticulture/sericulture under dry land agriculture in particular and irrigated farming in general.
- Provision of adequate credit to support post-harvest management requirements, *viz.*, agro-processing, storage/preservation, transport, packaging and marketing farm commodities in domestic and international markets.

- Supporting rural and social infrastructure for a sustainable integrated rural development which has suffered quite considerably in the past several years.
- RFIs have to build up their capacity to manage cost, risk and non-performing assets prudentially while performing the above tasks.

THE BANKING SYSTEM

The structure of the banking system is determined by two basic factors — economic and legal. The development of the economy and the spread of banking habit calls for increasing banking services. The demand for these banking services affects the banks' structure and organisation. National objectives and aspirations result in government regulations, which have a profound influence on the banking structure. These regulations are basically of two types. *First*, regulations which result in the formation of new banks to meet the specific needs of a group of economic activities. *Secondly,* legislation that affects the structure by means of nationalisation, mergers or liquidation.

Progress of Commercial Banking in India

	June 1969	*March 2008*	*March 2012*
Public Sector Banks	22	28	26
Regional Rural Banks	—	95	81
Foreign Banks	14	29	38
Other Scheduled Commercial Banks	37	23	21*
Total	73	175	166

* Including 7 new Private Sector banks

Source: Trend and Progress.

The Reserve Bank of India, as the central bank of the country, is at the head of this group. Commercial banks themselves may be divided into two groups, the scheduled and the non-scheduled, the former banks being akin to member banks in the Federal Reserve System of the USA. Their names are included in the Second Schedule of the Reserve Bank of India Act and they are entitled to borrowing facilities from the Reserve Bank. On their part, they are required to maintain a certain minimum balance in their accounts with the Reserve Bank of India, and do certain other things prescribed by law. They come within the direct influence of the various credit control measures of the Reserve Bank; and the effects of these measures diffuse through the length and breadth of the economy.

The commercial banking system may be distinguished into:

Regional Rural Banks (RRBs) were set up under the Regional Rural Banks Act, 1976. RRBs were expected to operate as State sponsored, region based and rural oriented commercial banks. The basic objective of this set of rural financial institutions was to have a feel and familiarity with local need. and professionally managed alternative channel for credit dispensation to small and marginal farmers. agricultural laborers. Social economically weaker sections of population for

development of agriculture, trade, commerce, industry and other productive activities. RRBs were expected to mobilise resources from rural areas and playa significant role in developing agriculture and .rural economy by deploying mobilised resources in rural sectors for the needy not covered by SCBs despite their large network. Keeping this objective in the view capital of RRBs is held by the Central Government concerned State Government and sponsor bank in the proportion of 50:15:35.

PRIVATE SECTOR BANKS

(*i*) Other Private Banks;

(*ii*) New sophisticated Private Banks;

(*iii*) Co-operative banks included in the second schedule;

(*iv*) Foreign banks in India, representative offices; and

(*v*) Non-scheduled banks.

The banks in the last group are prominent names in the country's foreign trade, of which they once held almost a monopoly, the Indian banks confining themselves to domestic business. In the post-World War II period, major Indian banks have achieved a notable growth, and now occupy an important place in the country's foreign trade. Until the Reserve Bank of India (RBI) came into existence, and for a considerable time afterwards, the State Bank of India (then known as the Imperial Bank of India) used to be a source of financial accommodation to the rest of the banking system, thus performing a part of the functions of the central bank, though not the main central banking function, *viz.,* discretionary control of the credit mechanism. However, with the progress of development plans, and with the growth of demand for bank finance by various sectors of the economy, the quasi-central banking functions of the State Bank of India (SBI) gradually disappeared. On the other hand, the nationalised sector, headed by the State Bank of India, has been given special responsibilities in connection with the development of banking in unbanked areas, and provision of finance to the small-scale industries sector and the co-operative industries sector. In terms of organisation, size and methods of operations, these compare quite favourably with similar institutions in the more developed countries.

The Reserve Bank of India and the commercial banks form the organised money market in India, the core of which is the inter-bank call money market. The rate of interest in this section of the market is the most sensitive indicator of the day-to-day developments in the money market. The market has a host of ancillary institutions, such as call-loan brokers, general finance brokers, stock brokers, and so on. The unorganised sector of the money market consists largely of indigenous bankers. In the course of time, deposit banking, which was introduced in the stet of the last century, has come to acquire a position of overwhelming importance in the monetary system of the country. The indigenous bankers have correspondingly lost their importance.

CO-OPERATIVE SECTOR

The co-operative banking sector has been developed in the country to supplant the village moneylender, the predominant source of rural finance, as the terms on which he made finance available have generally been usurious and detrimental to the development of Indian agriculture. Although the sector receives concessional finance from the Reserve Bank, it is governed by the

State legislation. From the point of view of the money market, it may be said to lie between the organised and the unorganised markets.

A very significant feature of the Indian money market (organised and unorganised) is the strong seasonality which derives from the seasonal crop pattern, as a result of which substantial amounts of funds are required during the busy season, lasting approximately between November and April,

(*a*) To finance the movement of crops from the producing to consuming centres within the country; and

(*b*) To finance exports based on agricultural commodities. This leads to an expansion of bank credit.

During the next six months, May-October, the funds return to the banking system and bank credit contracts. Although as a result of the process of industrial development and other factors, this pattern is modified somewhat, the seasonality still persists to a marked degree. As will be seen later, it has an important bearing on the Bank's credit control policy.

The co-operative banking structure in India is divided into four component parts:

PRIMARY CO-OPERATIVE CREDIT SOCIETIES

The primary cooperative credit society is an association of borrowers and non-borrowers residing in a particular locality. The funds of the society are derived from the share capital and deposits of members and loans from Central Co-operative Banks. The borrowing power of the members as well as of the society is fixed. The loans are given to members for the purchase of cattle, fodder, fertilisers, pesticides, implements, etc.

CENTRAL CO-OPERATIVE BANKS

These are the federations of primary credit societies in a district, and are of two types — those having a membership of primary societies only and those having a membership of societies as well as individuals. The funds of the bank consist of share capital, deposits, loans and overdrafts from State Co-operative Banks and joint stocks. These banks finance member societies within the limits of the borrowing capacity of societies. They also conduct all the business of a joint-stock bank.

STATE CO-OPERATIVE BANKS

The State Co-operative Bank is a federation of central co-operative banks and acts as a watchdog of the co-operative banking structure in the State. Its funds are obtained from share capital, deposits, loans and overdrafts from the Reserve Bank of India. The State Co-operative Banks lend money to central co-operative banks and primary societies and not directly to farmers.

LAND DEVELOPMENT BANKS

The Land Development Banks, which are organised in three tiers, namely, State, Central and Primary level, meet the long-term credit requirements of farmers for developmental purposes, *viz.*, purchase of equipment like pump sets, tractors and other machineries, reclamation of land,

fencing, digging up new wells and repairs of old wells, etc. Land Development Banks are co-operative institutions and they grant loans on the security of mortgage of immovable property of the farmers. These banks have a two-tier organisational structure — at the state level, there are Central Land Development Banks and at the district or *taluka* level, there are Primary Land Development Banks. In some states like Gujarat, Jammu & Kashmir and U.P., the structure is unitary, i.e., there are Apex Land Development Banks which operate directly through their own branches at the district level.

The financial resources of the Central Land Development Banks are raised by floating debentures in the market. Such debentures carry the guarantee of the State Government and are subscribed by the Central and State Governments, Commercial Banks, Life Insurance Corporation and other Land Development Banks as a measure of mutual support. Land Development Banks also avail of the refinancing facilities provided by the National Bank for Agriculture and Rural Development (NABARD) in respect of the term loans granted by them for the schemes of agricultural development. They also secure short-term accommodation from the State Governments, Commercial Banks and the State Co-operative Banks.

DEVELOPMENT BANKS

Another important feature of the structure and organisation of Indian banking system is the establishment of many financial corporations, which provide finance to those sectors of the economy to which commercial banks do not provide finance.

It becomes difficult for commercial banks to participate in the financing of long-term requirements of the industry. Mixed banking also has certain disadvantages. Although mixed banking has been successful in Germany and some other countries, it cannot be relied upon in a developing country like India, where banking habits are still in a nascent stage. At best, our bigger banks can resort to term lending in a limited way. Therefore, certain special institutions are necessary to handle the problem of long-term financing of industries. Broadly speaking, such institutions are known as "Development Banks."

Medium and long-term finance is provided mainly by a few large development banks with all-India status, and state level institutions in the various states. For each category of term financing activity, an apex all-India development bank has been promoted — Industrial Development Bank of India, National Bank for Agriculture and Rural Development, Export Import Bank of India, National Housing Bank, etc. Besides these development banks, All-India investment institutions such as Unit Trust of India, Life Insurance Corporation, General Insurance Corporation also play a major role in channelling financing savings to the industrial and other sectors. There are besides, institutions exclusively supporting tourism, small scale industry, etc. In recent years, a number of public sector mutual funds set up by banks and financial institutions have been added to the institutional framework. Para-banking activities, mainly in the area of hire-purchase and leasing are undertaken by newly set up large number of private sector non-banking financial companies.

MONEY MARKET

The vital capital market has evidenced tremendous growth in the last decade in terms of resource mobilisation, listing and market capitalisation. Activities in a network of 26 stock exchanges listing over 6,000 companies, are being regulated by the special purpose institution

— Securities & Exchange Board of India (SEBI). The development of short-term money market has, however, lagged behind that of other sub-sectors of the market. It comprises five segments — the call money market, inter-bank term deposit market, bills rediscounting market, treasury bills market and the inter-corporate funds market.

The Discount & Finance House of India Ltd., (DFHI) is the leader of the money market, namely, of money overnight to a fortnight in the case of inter-bank market, money for a few days to a few months in the case of treasury bills, commercial bills, commercial paper, etc. Since 1992, DFHI has been permitted to operate in the government securities also. SEBI was empowered in 1992 to regulate legally all intermediaries and operations in the stock and capital markets. Stock brokers, dealers and a host of other intermediaries, controlled and regulated by the RBI and SEBI are part of the organised financial system in India. The RBI is the leader in the money market and SEBI is the regulator in the capital market in the organised system.

Mutual funds, both in the public sector and private sectors, play a key role in mobilising savings and in the market operations.

Similarly, moneylenders and indigenous bankers are licenced under the State laws and regulated by the State agencies. But there is hardly any system of regulation on them worth the name.

While the capital market is a wider term encompassing all long-term borrowings and lendings, issue of long-term securities, and all unsecuritised debts of long-term nature, the new issue market in particular relates to the new issues of marketable securities by existing or new companies. These two together fall into the organised financial system.

The inter-relations and relevant sub-markets are visually shown in the chart below:

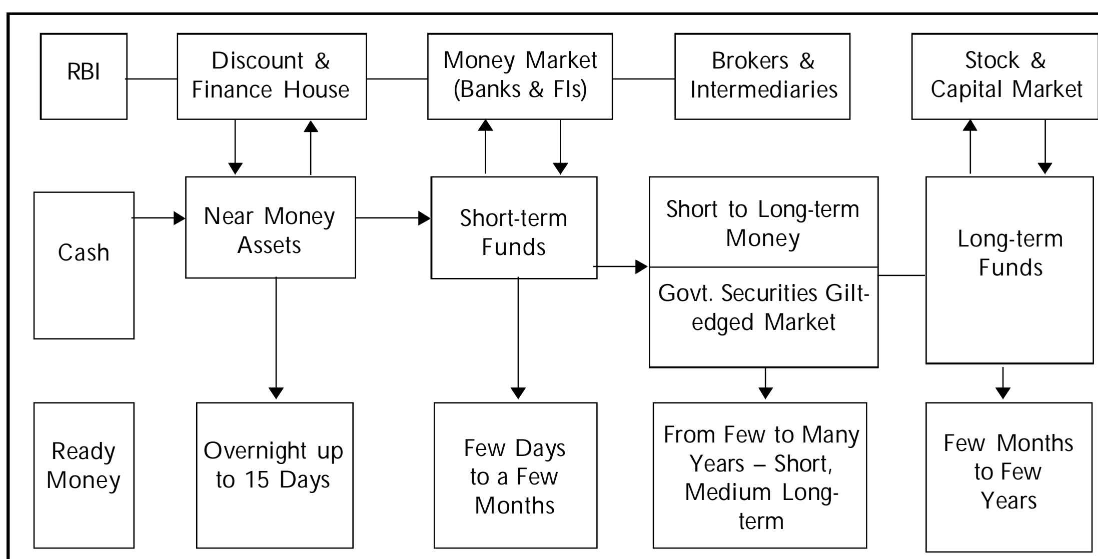


Figure 2.1: Money and Stock Markets

FINANCIAL COMPANIES

These investment and finance companies, housing finance, chit funds, etc., also mobilise and channel savings into investment. They are only partly controlled by the Reserve Bank in respect of resource mobilisation through deposits. For the rest of their activities, they are controlled and regulated like any other company by the Registrar of Companies, under the Companies Act. Similarly, moneylenders and indigenous bankers are licenced under the State laws and regulated by the State agencies. But there is hardly any system of regulation on them worth the name.

While the capital market is a wider term encompassing all long-term borrowings and lendings, issue of long-term securities, and all unsecuritised debts of long-term nature, the new issue market in particular relates to the new issues of marketable securities by existing or new companies. These two together fall into the organised financial system.

Micro Finance Institutions

Micro finance is the provision of thrift, credit and other financial Services and products of very small amount to the poor in rural, semi-urban areas for enabling them to raise their income levels and improve their standards. Micro finance delivery through micro finance institutions (MFIs) has been a popular model. The MFIs are characterised by diverse institutional and legal forms. During the year 2008-09, bank loan amounting to ` 3,732 crore was disbursed to 581 MFIs, taking the total loan outstanding to ` 5,009 crore to 1915 MFIs as on March 31, 2009. The Micro-finance movement has been playing a crucial role in the financial inclusion efforts. Thus, MFIs have emerged as a new player in the Indian financial systems.

ROLE OF THE GOVERNMENT

In the Indian context, the Government initiated the process of remodelling the financial system to ensure that resources were allocated in accordance with their development strategies. Towards this end, the Government nationalised banks, created new financial institutions, directed other financial institutions to channelise their resources to the sectors that are to be at the forefront of industrial development. The Government also set up specialised supervisory as well as refinance apex institutions to foster the development of agriculture, industry, small-scale sector, exports, rural industries, housing, leasing, merchant banks and mutual funds. The Government also borrowed heavily, both from the domestic financial system and abroad, to finance budget deficits and the needs of the state-owned undertakings in the core sectors. This apart, the government directly participates in mobilising resources through its agencies like postoffice and provident funds and/or pension funds. Through the postoffice, it also operates small savings, supplemented by the National Savings Organisation. In addition, postoffice offers savings bank and insurance schemes and services.

EMERGING FINANCIAL SYSTEM

In the years to come, there is no doubt that the Indian financial system will grow in size and complexity. Different segments of the market will become closely linked and it will become difficult to influence or act on only one segment without affecting others. The major link

connecting the various segments will be the interest rate as is the case in many of the industrially advanced countries now. In order to influence the entire system, the monetary authorities will have to act on interest rates.

Banks will begin to function increasingly under competitive pressures. These pressures may emanate from within the banking system as well as from non-banking institutions. With the increasing participation of private shareholders even in public sector banks, there will be greater accountability to shareholders, including the Government. Competitive pressures can also result in some degree of consolidation.

Another area which will become important relates to regulatory harmonisation among various regulators, both domestic and international, of the financial markets including capital markets. Regulators will have to increase efforts towards converging their policies and procedures and have a greater element of information share.

The role of financial supervision in a system that is rapidly emerging as market based is an important one. The current supervisory approach emphasises follow-ups and compliance by the financial intermediaries with banking policy and credit allocative directives and foreign exchange regulations.

In the changing circumstances, bank supervisors will have to focus on issues which ensure the safety and soundness of the system, depositor protection and reduction of systematic risk. These are issues which will have important monetary policy implications. Ensuring compliance with prudential norms will be a major task. The supervisory system has a two fold task: it must be responsive to changes that are occurring in the financial markets and it must simultaneously instil confidence in the integrity and soundness of the markets and the participants in the market.

CONCLUSION

The Indian financial system is broad-based, yet inadequate and less efficient. Efficient financial systems will help India to grow, partly by mobilising additional financial resources and partly by allocating these resources to the best uses. As economies develop, so must the financial systems that serve them. The next chapter illustrates the central role of finance in development by reviewing the macro-economic dimensions of the financial system, *viz.,* institutions, instruments and markets.

Further, different segments of the market will become closely linked making it difficult to influence or act on only one segment without affecting others. The major link connecting the various segments will be the interest rate as is the case in many of the industrially advanced countries now. In order to influence the entire financial system, the monetary authorities will have to act on interest rates. There will be increasing specialisation; simultaneously, there can emerge financial conglomerates dealing in different financial products and services. The existence of healthy and sound financial institutions should be able to put pressure on investors and other borrowers, to use resources in an efficient and productive manner in order to repay the existing obligations and qualify for new finances for major projects.

SELF ASSESSMENT QUESTION

(1) Explain in detail the structure of the Indian Financial System

(2) Discuss the role of financial institution in the economic.