CHAPTER

3 FUNCTIONS AND ROLE OF THE FINANCIAL SYSTEM

INTRODUCTION

Financial system plays a very important role in our economy; in fact, it is difficult to imagine how our economic system could function efficiently without many of their services. The financial systems are the heart of our economic structure, since they have the ability, in co-operation with the Reserve Bank of India, to cater and add to the money supply of the nation and thus create additional purchasing power.

In this chapter, focus is on the functions of the financial system.

FINANCE FUNCTION

Finance is the key input of an economy. It is rightly termed as *the science of money*. We need finance for the production of goods and services as well as their distribution. The efficiency of production and marketing operations are directly influenced by the manner in which the finance function of the enterprise is performed by the finance personnel. Finance function assumes an important role in the business system and it should be given equal importance, as with production and marketing functions. Under the systems approach we have an integration and coordination of these three vital sub-systems of business going hand in hand and offering both ways and means to accomplish the common goals of the enterprise, *viz.*, productivity and satisfaction.

Finance is that administrative area or set of administrative functions in an organisation which relate with the arrangement of cash and credit, so that the organisation may have the means of to carry out its objectives as satisfactorily as possible.

The major objectives of finance function are:

1. Mobilisation of resources for the economy;
2. Channelising the money in productive activities;
3. Generating income or profit;

4. Creating assets for the use of masses;
5. Contributing to the activities of promotion of the economy; and
6. Equitable development of the economy. In the process, finance transforms the economy.

FINANCIAL INTERMEDIARIES

Financial intermediaries are the institutions which collect savings from others, issuing in return claims against themselves, and use the funds thus acquired to purchase ownership or debt claims, such as: banks, financial institutions, investment institutions and financial intermediaries. They are interposed between ultimate borrowers and lenders to acquire the primary securities of borrowers and provide other securities for the portfolios of lenders. Their outstanding feature is that they issue to savers claims whose characteristics are quite different from those that they buy and hold. They do not merely intermediate, but in the process they also create higher degree of safety and liquidity. Their basic function is to satisfy simultaneously the portfolio preferences of lenders and borrowers.

The increasing differentiation of financial assets tends to promote the development of financial structure. New types of financial assets are created to suit the needs of different spending units and a variegated structure of financial intermediaries emerges out in a rapidly developing economy. Markets for goods and markets for securities are simultaneously the media through which spending units seek optimal adjustment between income and spending, networth and wealth.

Financial intermediaries play a very important role in the saving-investment process by raising the level of saving and investment and allocating more efficiently scarce savings among most productive investments. Commercial banks, which are one of the oldest financial intermediaries, often fall short of the diversified requirements of ultimate savers and investors. This creates a favourable climate for the emergence and growth of NFI. The new specialised types of financial assets are created to suit the demand structure and an array of new types of financial intermediaries are established to meet the demand for increasing specialisation.

A satisfactory classification of financial intermediaries will vary from place to place and time to time. Generally, they are grouped under five different categories as follows:

1. The banking system (Central Bank, Commercial Banks, Co-operative Banks, Savings Banks, etc.)
2. Other depository organisations (mutual funds, savings and loan associations, credit unions, etc.)
3. Insurance organisations (Life Insurance, General Insurance, Postal Insurance, Pension Funds, Provident Funds, etc.)
4. Development Banks, and
5. Other financial intermediaries (investment and finance companies, Stock Exchanges and other related intermediaries.)

Function of the financial system is the sum total of functions of varied financial intermediaries. The functions of the financial system extend from creation of money to proper management. It touches all aspects of the economy.

Let us recapulate the functions of key financial intermediaries to have a broad view of the functions of the financial system.

REGULATORY FUNCTIONS

1. Banker's bank
2. Supervision of financial institutions
3. Regulation of stock exchanges
4. Implementing monetary controls
5. Controlling foreign exchange
6. Directing investment, etc.,
7. Licensing, inspection and control.

DEVELOPMENTAL FUNCTIONS

1. Deposit insurance
2. Credit guarantee
3. Credit information
4. Training of intermediaries
5. Investor's education
6. Promotion of fair practices
7. Training of personnel
8. Collection of data and publications
9. Conducting research
10. Institutional building and development
12. Creating financial awareness
13. Management update
14. Broad-basing entrepreneurship
15. Upgrading managerial skills
16. Revival of sick units
17. Promotion of self-employment.

RESERVE BANK OF INDIA — THE CENTRAL BANK

The Reserve Bank of India (RBI) is the apex monetary institution in the money market which acts as the monetary authority of the country, and serves as the government bank as well as the bankers' bank. It undertakes major financial operations of the government; by its conduct of these operations and by other means, it influences the behaviour of financial institutions to ensure that they support the economic policy of the government. The Central Bank differs from other financial institutions. *First,* it differs in that it is controlled by the people who are more or less closely connected with other organs of the government. *Second,* it does not exist to secure the maximum profit, which is the principal aim of a commercial bank. *Third,* the Central Bank must have a special relation with the commercial banks whereby it may influence the operations of these institutions in the implementation of the government's economic policy. In brief, the Central Bank is an organ of the government which, by reason of its operations, influences the working of financial institutions of the country. In India, the RBI is the Central Bank of the country.

The main function of the Central Bank is to regulate the monetary mechanism comprising of the currency, banking and credit systems. For this purpose, the bank is given wide powers. Another important function of the central bank is to conduct the banking and financial operations of the government. Besides, it discharges certain other functions. These functions are performed with a service motive and not for making profits. The functions of the Central Bank and the obligations resting upon it are of a very special character, calling for skill, experience and judgement of a kind different from those required from a commercial bank.

The functions of the Reserve Bank of India are:

(*i*) Issue of bank notes, maintenance of currency chests

(*ii*) Banker's bank

(*iii*) Foreign exchange management and control

(*iv*) Government banker

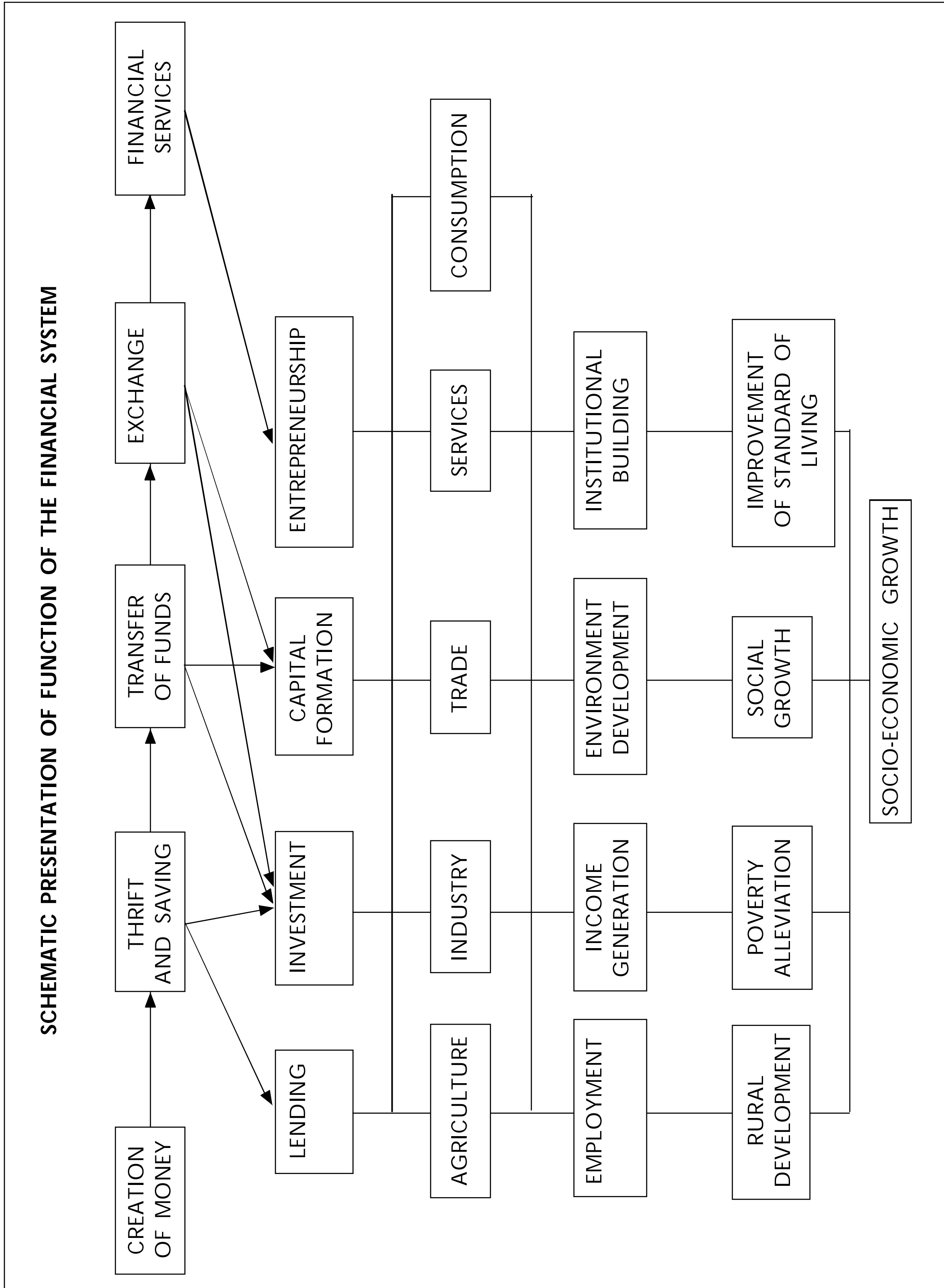
(*v*) Other subsidiary or ancillary functions

(*vi*) Monetary authority of the country and

(*vii*) Promotional and development activities.

COMMERCIAL BANKS

Commercial banks are the heart of our financial system. They hold the deposits of millions of persons, governments and business units. They make funds available through their lending and investing activities to borrowers — individuals, business firms, and governments. In doing so, they facilitate both the flow of goods and services from producers to consumers and the financial activities of governments. They provide a large portion of our medium of exchange and they are the media through which monetary policy is effected. These facts obviously add up to the conclusion that the commercial banking system of the nation is important to the functioning of its economy.


SCHEMATIC PRESENTATION OF FUNCTION OF THE FINANCIAL SYSTEM
CREATION OF MONEY
THRIFT AND SAVING
TRANSFER OF FUNDS
EXCHANGE
FINANCIAL SERVICES
LENDING
INVESTMENT
CAPITAL FORMATION
ENTREPRENEURSHIP
AGRICULTURE
INDUSTRY
TRADE
SERVICES
CONSUMPTION
EMPLOYMENT
INCOME GENERATION
ENVIRONMENT DEVELOPMENT
INSTITUTIONAL BUILDING
RURAL DEVELOPMENT
POVERTY ALLEVIATION
SOCIAL GROWTH
IMPROVEMENT OF STANDARD OF LIVING
SOCIO-ECONOMIC GROWTH

Commercial banks play a very important role in our economy; in fact, it is difficult to imagine how our economic system could function efficiently without many of their services. They are the heart of our financial structure, since they have the ability, in co-operation with the Reserve Bank of India, to add to the money supply of the nation and create additional purchasing power. Banks' lendings, investments and related activities facilitate the economic processes of production, distribution and consumption.

The major task of banks and other financial institutions is to act as intermediaries, channelling savings into investment and consumption: through them, the investment requirements of savers are reconciled with the credit needs of investors and consumers.

If this process of transference is to be carried out efficiently, it is absolutely essential that the banks are involved. Indeed, in performing their tasks, they realise important economies of scale: the savings placed at their disposal are employed in numerous and large transactions adapted to the specific needs of borrowers. In this way, they are able to make substantial cost savings for both savers and borrowers, who would otherwise have to make individual transactions with each other. However, there is more to these economies of scale than just the cost aspect.

Commercial banks have been referred to as '*department stores* of *finance*' as they provide a wide variety of financial services. In addition to the acceptance of deposits, lending and investing, they provide a multitude of services, including transfer of funds, collection, foreign exchange, safe custody, safe deposit locker, traveller's cheques, merchant banking services, credit cards, gift cheques, etc. They also play an important role in entrepreneurship development. The functions of commercial banks touches all economic activities from agriculture, industry, trade, exports and consumption.

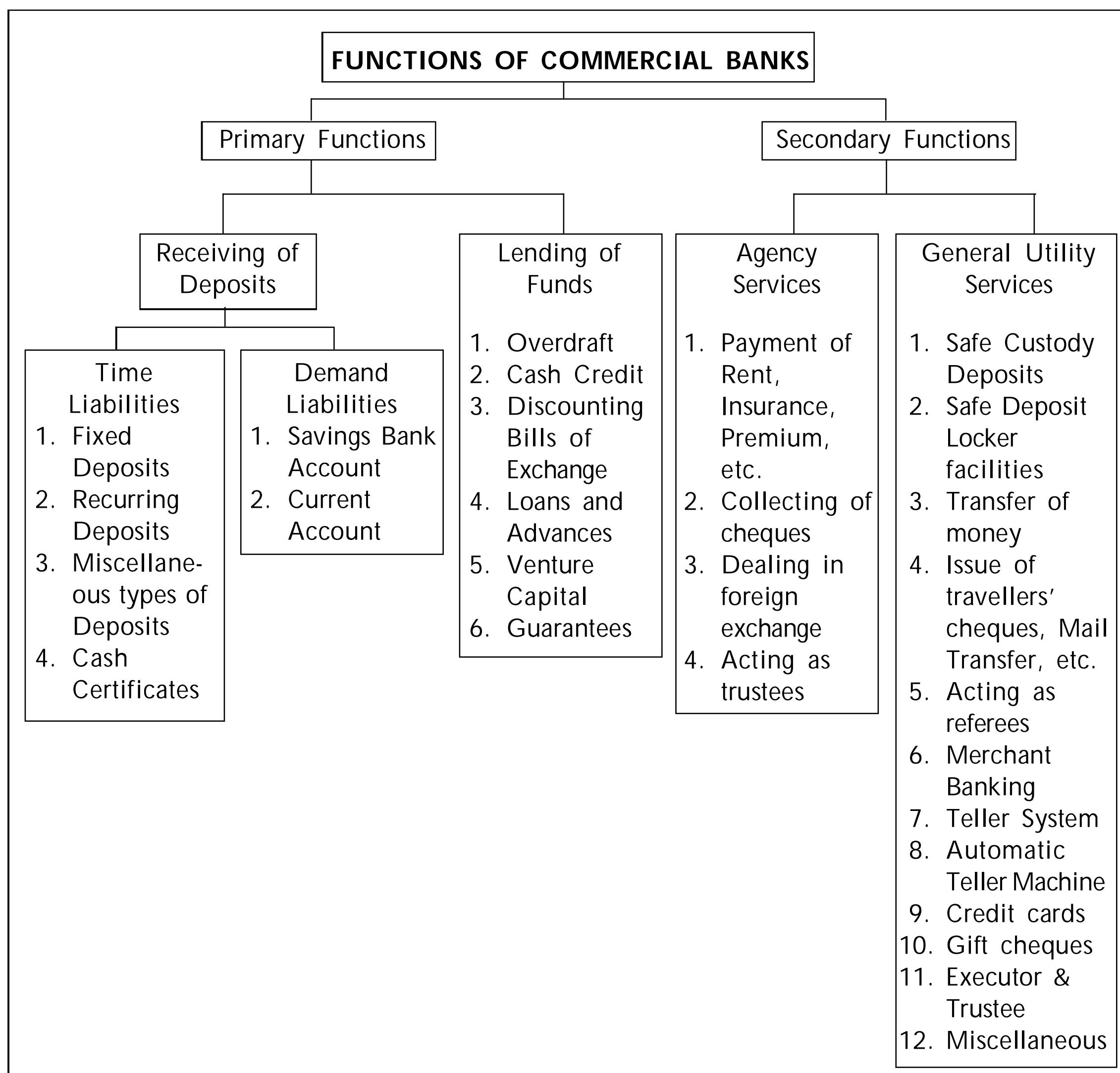
Similarly, co-operative banks offer many of these services in rural areas.

The complexion of the Indian banking scene is all set to see a remarkable change. With the entry of new private banks on a large scale, the expansion of foreign bank branches made easier, the number of non-banking financial institutions and their business growing fast, the banks are in the middle of a tough competitive arena.

MUTUAL FUNDS

A mutual fund is basically a risk reduction tool. Risk reduction is achieved by *diversification* of the portfolio. Diversification means that a mutual fund invests in a large number of shares and instruments which lowers the risk. Further, the fund managers' investment decisions are based on the basis of intensive research and are backed by informed judgement and experience. A mutual fund collects money from investors and invests it for them. The entire income/profits are distributed to the investors in proportion to their investments. The pooling of funds from a large number of investors ensures that the total corpus of a mutual fund is very large. Due to the large funds, mutual funds are normally able to buy cheaper and sell dearer than individual investors. This is because of better market rates and lower rates of brokerage.

Secondly, optimum diversification is possible because of large funds. Whereas an individual investor cannot hold more than a few companies' shares because of limited funds, a mutual fund invests in a large number of shares to reduce risk. In simple terms, a mutual fund follows the saying "*Don't put all your eggs in one basket.*" This reduces the risk for the investor.



Unit Trust of India, the first mutual fund, was established in 1964. There are over 30 mutual funds operating in the country. Together, they have mobilised over ` 85,000 crore and employed the funds in equity and income securities of companies.

INSURANCE COMPANIES

As on April 1, 2000 insurance industry comprised two players: the state insurers – LIC and GIC.

Life Insurance Corporation of India (LIC) guarantees full protection against risk of death of the saver. The main functions of Life Insurance Corporation are:

(*i*) Mobilise people's savings through insurance-linked savings schemes;

(*ii*) Encourage thrift;

(*iii*) Invest the funds productively; and

(*iv*) Spread life insurance and provide life insurance protection at a reasonable cost.

The insurance companies will, within the statutory framework, continue to strive to provide better and better returns to the policyholders, whose money it holds in trust. For, in the ultimate analysis, the responsibility of ensuring that *"peoples' money is used for peoples' welfare" will be* the prime motivating factor in planning investments.

The General Insurance Corporation of India (GIC) established since the nationalisation of general insurance companies in the country in 1973 and its four subsidiaries, *viz.,* National Insurance Co. Ltd., New India Assurance Co. Ltd., Oriental Fire & General Insurance Co. Ltd., and United India Insurance Co. Ltd., operates a number of insurance schemes to cater to the diverse needs of various sections of society. In accordance with the guidelines issued by the Government of India from time to time and in terms of the provisions of the Insurance Act, 1938, 70% of annual accretions to investible funds to the general insurance industry are required to be channelised into socially-oriented sectors of the economy. GIC's market operations (sale and purchase of corporate securities) have a stabilising effect of the stockmarket. GIC has been providing financial assistance to the industrial sector by participating with other AIFIs in consortium financing of the industrial sector projects since 1976, by extending term loans and underwriting of equity shares/preference shares/debentures of both existing and new industrial undertakings.

With effect from December 2000, GIC has been a national Reinsurer and its four subsidiaries have been delinked from the parent company and made as independent insurance companies.

The measures go a long way in rebuilding confidence (financial & human) mobilising savings, giving boost to trade, especially export, boost to financial health and protection to property and lives. In turn, industry sets an impetus for growth.

The insurance sector serves as an important financial intermediary providing insurance cover, both on life and other risks. It is also an important source of funds for the corporate sector as also the Government to direct investment into socially desired sectors.

Likewise, postal insurance, provident funds and, pension funds provide financial security to savers as well as provide funds for development activities of the governments. Similarly, small savings too mobilise savings and encourage thrift (that is economising).

DEVELOPMENT BANKS

Development banks are those banks engaged in the promotion, development of industry, agriculture and other key sectors. These banks differ from commercial banks in the sense that they do not mobilise savings of the people but invest the resources in a productive manner. Additionally, these banks provide all the developmental services, so as to accelerate the growth of the economy.

In one sense, the operations of this institution are no different from other financial intermediaries, being characterised by either lending or investment or both. However, in another sense, the development financing institution is created to fulfil a vitally different need. Its *raison*

d'etre is to further the cause of development. The nature of its banking activity has to be such as would assist that process. It is a chosen instrument for facilitating and stimulating economic growth. The traditional commercial banks, on the other hand, were guided more or less by commercial considerations, though the character of commercial banking has changed a great deal in recent years towards a developmental role.

The task of a development finance institution is complex and the course of its journey, tortuous. However, glorious the ideal of development, those charged with its realisation need to be imbued with vision as they steer along their path, facing many impediments.

A development bank has the opportunity to promote enterprises, that is, to conceive investment proposals and to stimulate others to pursue them or itself to carry them through from conception to realization. In principle, a development bank is well suited to assume this kind of role. Yet enterprise creation is fraught with costs and risks which a development bank cannot neglect. Development banks can prudently undertake them only when they have the requisite financial strength, technical expertise and the managerial skill to deal with them effectively.

In India, the process of institutionalized industrial development financing dates back to 1948 when the first development bank, the Industrial Finance Corporation of India Ltd., (IFCI) was established. Since then, development banking in India has seen a sea change. A network of development banks have come into operation in industry, agriculture and international trade both at the national and the state levels. They have been playing a catalytic role in India's economic development. The scale and scope of their activities have been broad-based so as to be in tune with national objectives.

Financial Institutions comprise of All-India Development Banks, *viz.,* Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India Ltd. (IFCI), Industrial Credit and Investment Corporation of India Ltd. (ICICI), Small Industries Development Bank of India (SIDBI), Industrial Investment Bank of India (IIBI), Specialised Financial Institutions, *viz.,* Risk Capital and Technology Finance Corporation Limited (RCTC), Technology Development and Information Company of India Ltd. (TDICI), Tourism Finance Corporation of India Ltd. (TFCI), Investment Institutions, *viz.,* Unit Trust of India (UTI), Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) and its subsidiaries and State-level Institutions, *viz.,* State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs).

A well-developed money market provides various kinds of credit instruments, augments supply of funds, enhances the amount of liquidity, arranges for quick transfer of funds and helps to enhance the profit of financial institutions and individuals through its varied profitable investment opportunities for short-term surplus funds.

CONCLUSION

The financial innovations which have emerged in the international markets, would in some measure be coming to India. The liberalisation process initiated in our country augurs well for diversification of banking business and for offering the financial services. The gradual process of introducing instruments like commercial paper, certificate of deposits, etc., will be of help in that direction. Banks, however, willl have to recruit people with the financial background,

impart to them the necessary for expanding and diversifying the services. The information system will have to be revamped in which the mechanisation process will play a major role. Because of the exchange control regulations, the scope for interest rate swaps will be limited. But other financial innovations like global custody could be considered by the banking system in India. The entire process, however, will have to be graula and this should be the watchword for the liberalisation process.

All these developments have resulted in the board banding of the financial sector, which is no doubt welcome. However, these very development raise certain moot issues. Most significantly, in the enthusiasm for venturing into never and apparently profitable lines, a lot of risk-taking is going on. In the present bening capital market mood, high returns are being promised to investors. Competition has also led to non-adherence of prudent margin requirements. Futher, since the track record in most of these ventures is negligible or nil, regulatory statutes are also in the evolutionary stage only. Another hindering factor is the support services in the from of technical and computer aids. These are certain aspects which need to be tackled in the future.

The tasks ahead are no doubt challenging but a major factor underlying the same is their inevitability. At this stage, our response as bankers is crucial. Admittedly, commercial banks are prudent risk avoiders and rightly so, but we cannot afford to be laggard. To avoid this, we have to be responsive to the environment, which may look risky today but complacency at this stage will only endanger future earning prospects. Such a line of action has obvious implications on the development of specialist manpower, use of advanced techniques and overall keeping up or rather ahead of developments. During the nineties, financial institutions have to concentrate more on the management of fund-based resources as an effective means of development. The changing environment of competition amongst the different segments of the financial system would call for a different work and management ethos, much more professional-oriented and determined to record good performance levels.

SELF ASSESSMENT QUESTION

(1) Explain the financial function

(2) Discuss the role of financial intermediaries.

(3) What are the regulatory functions of Reserve Bank of India and others.