Lesson - 1

# FINANCIAL SERVICES AND FINANCIAL MARKETS

## 1.0 Objective:

After studying this lesson, you shall be able:

* to understand the concept of Financial System.
* to know about the objectives of Financial System.
* to understand about Financial Market and its participants.
* to know about the concept of Financial Services and examine various types of Financial Services.

## Structure:

## 1.1 Financial System:

The financial system is the most important institutional and functional vehicle for economic transformation. It is a set of interrelated activities and services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, investment of capital and growth. Van Horne defines the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. Robinson defines financial system as "a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the issuing wealth'. From the above definitions, it may be said that the primary function of the financial system is the mobilisation of savings, their distribution for industrial investment and stimulating capital formation to accelerate the process of economic growth.

A financial system provides services that are essential in a modern economy. Financial assets with attractive held, liquidity and risk characteristics encourage savings. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables an economic agent to pool, price and exchange risks in the markets. Trade, the efficient use of resources, saving and risk taking are the cornerstones of a growing economy. The financial system has been identified as the most catalysing agent for growth of the economy, making it one of the key inputs of development.

**Structure of the Finance System:** The Indian Financial System is broadly classified into two broad groups i.e., (1) Organised sector, (2) 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 users of the financial services. The providers of financial services are central bank, commercial banks, financial institutions, Money and capital markets, non-banking institutions etc.,

**Organised 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 cooperative banking structure. About 85 percent of such banking business is managed by twenty seven public sector banks. In addition to commercial banks, there is the network of comparative 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 of such as merchant banking, mutual funds, leasing factoring and insurance etc.,

The organised financial system consists of the following sub systems:

* Banking System
* Cooperative System
* Development Banking
    (i) Public Sector
    (ii) Private Sector
* Money Markets
* Financial Companies/Institutions

Over the years, the structure of financial institutions in India has developed and become broad based with diversification.

**Unorganised Financial System:** The unorganised financial system comprises money lenders, indigenous bankers, lending pawn brokers, landlords, traders etc., This part of the financial system is not directly under the control of the Reserve Bank of India. There are a host of financial companies, investment companies, chit funds etc., which are not regulated by the RBI or the government in a systematic manner.

## Organised Financial System:

**Banking System:** The structure 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 RBI, the central bank of the country is at the top of the financial system. The commercial banking system can be divided into four as given hereunder.

**I. Public Sector Banks:**

- State Bank of India, Associate Banks } State Bank group 1 + 7
- 14 Nationalised Banks (1969)
- 6 Nationalised Banks (1980) 6-1 = 5

  1 Bank merged with another bank.
- Regional Rural Banks (196) (Sponsored by Public Sector Banks)

**II. Private Sector Banks:**

- Old Private Banks
- Newly set up Private Banks

**III. Foreign Banks & their Representative Offices:**

**IV. Cooperative Banks:**

- State Cooperative Banks
- Central Cooperative Banks
- Primary Agricultural Credit Societies
- Urban Cooperative Banks
- Land Development Banks

## Financial Systems and Development:

A financial system provides services that are essential in a modern economy. The Indian financial system comprises of an impressive network of banks, other financial and investment institutions offering wide range of products and services which together function in fairly developed capital and money markets. As such, financial system has come to occupy an important role in the process of economic development. The economic development of a country depends on its financial structure. Investment is a precondition of economic growth. This is essential to sustain growth of the economy. The more efficient composition of real wealth is obtained by the provision of financial assets which provide incentives to savers to hold a large part of their wealth in financial form. The increasing rate of savings is correlated with the increase in the proportion of savings held in the form of financial assets relative to tangible assets.

## 1.2 Objectives of Financial System:

The Indian financial system has been undergoing rapid changes particularly in relation to the emerging financial liberalisation. In the process, it has undergone a radical transformation in its structure and organisation. The main objectives of the financial system is to serve as an agent of socio-economic development in various sectors viz., industry, agriculture and international trade.

Objectives of Financial Systems

- Rapid Industrialisation
- Support to Agriculture
- Support to Trade
- Speeding up economic growth
- Rural Development
- Entrepreneurial Development
- Objectives of Financial System
- Project Finance
- Refinancing - Rediscounting
- Development of Backward areas
- Housing, Education, Health
- Infrastructure
- Liquidity
- Price Control
- Support to Institutions
- Research and Development
- Human Development
- Eradication of Poverty

The foremost task of any financial system is to accelerate the growth of the economy. Rapid industrialisation even in the private sector has been referred to as providing additional employment opportunity as well as higher production. Liquidity and Price Control motivate people to save and invest in development and thereby develop various segments of the economy and create vast employment opportunities, generate income, improve standard of living, eradicate poverty, ill health, illiteracy and sustain economic development.

### Role of the Financial System:

Financial systems provide payment services. They mobilise, savings and allocate credit. The diverse services used in the financial system are by households, business and government through an array of instruments like cheques, DDs, credit cards, bonds, stock, certificates, commercial papers, Billing Exchange etc;. A financial system's contribution to the economy depends on the quantity and quality of its services and the efficiency with which it provides them. Financial services make it cheaper and less risky to trade goods and services and to borrow and lend.

Finance is the key to investment and growth. Providing saved resources to others with more productive uses for them raises the income of saver and borrower alike. Without an efficient financial system, lending can be both costly and risky. Self financed investment is one way to overcome these difficulties but profitable investment opportunities may exceed the resources of the individual enterprise. Investment by the public sector is another answer and the government mobilises additional savings through tax system. When the economy is growing, financial arrangements need to be augmented by commercial banks, financial institutions. In a diversified market based system, the government retains a key role as prudential regulator to ensure sound development of financial system through effective, functioning of financial institutions.

### 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. They play a very important role in the saving investment process by raising the level of saving and investment and allocating more efficiently scare savings among most productive investments. Financial institutions are grouped under five different categories as given hereunder.

(1) Banking System (Central Bank, Commercial Banks, Cooperative Banks, Regional Rural Ranks)

(2) Depository Organisations (Mutual funds, Credit Unions etc.)

(3) Insurance Organisations (LIC, GIC, Postal Insurance, Pension Funds, Provident Funds etc.)

(4) Development Banks and

(5) Other Institutions (Investment and Finance Companies, Stock Exchanges etc.)

The financial system in India has undergone rapid changes. The financial system should facilitate the speedy growth of the economy. In recent years, the financial institutions are concentrating more on the management of fund based resources as an effective means of development. The changing environment of competition amongst different segments of the financial system should call for more professionalism and good performance levels.

## 1.3 Financial Markets:

Money, debt instruments and equities are called financial assets and they are claims against present and future income. These claims are traded in financial markets. Although some securities are traded directly between buyers and sellers after private negotiation, the major places for trading securities are called financial markets. Financial markets perform a vital function of allocating the wealth of the economy. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. The participants on the demand and supply sides of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers and others who are interlinked by the laws, contracts and communication network.

### Classification of Financial Markets:

The financial market comprises all banking and non banking financial institutions, procedures, practices followed in these markets and financial instruments for facilitating the flow of funds. The financial markets in an economy can be classified into:

(a) Primary and Secondary Markets and

(b) Money and Capital Markets.

### a) Primary and Secondary Markets:

Primary market deals with the new issues of securities, while the market for existing claims (financial assets) is known secondary market. In other/words, primary market deals with new securities issued for the first time to the public and the secondary market deals in those securities which have already been issued to the public. In the primary market, the brokers act as under writers, managers, registrars and even merchant bankers to the new issues. In the secondary market, the claims of long term nature of one year and above are traded both on spot and forward basis. This trading imparts liquidity to investments and thus promotes saving and investment. These claims can be converted into money at any time although at a loss of capital in various degrees.

In the primary market, the government and corporate sector issue securities and raise additional funds for investment purposes. In the secondary market, the existing securities change hands from one owner to another owner and there is no additional flow of funds for further investment. An active secondary market stimulates activity in the primary market. Thus, the level of development in the secondary market determines the efficiency and growth of the primary market.

### b) Money and Capital Markets:

Money Market is the place where short term claims (with a maturity period of one year or less) are traded. The money market facilitates short term financing and assures liquidity of short term financial assets. The money market is the central place for banking activities and is significant in indicating changes in short term interest rates, monetary policy and availability of short term credit. Money market assures borrowers that they can obtain short term funds quickly and it also assures the lenders that they can convert their short term financial assets into cash. A well developed money market is the basis for an effective monetary policy.

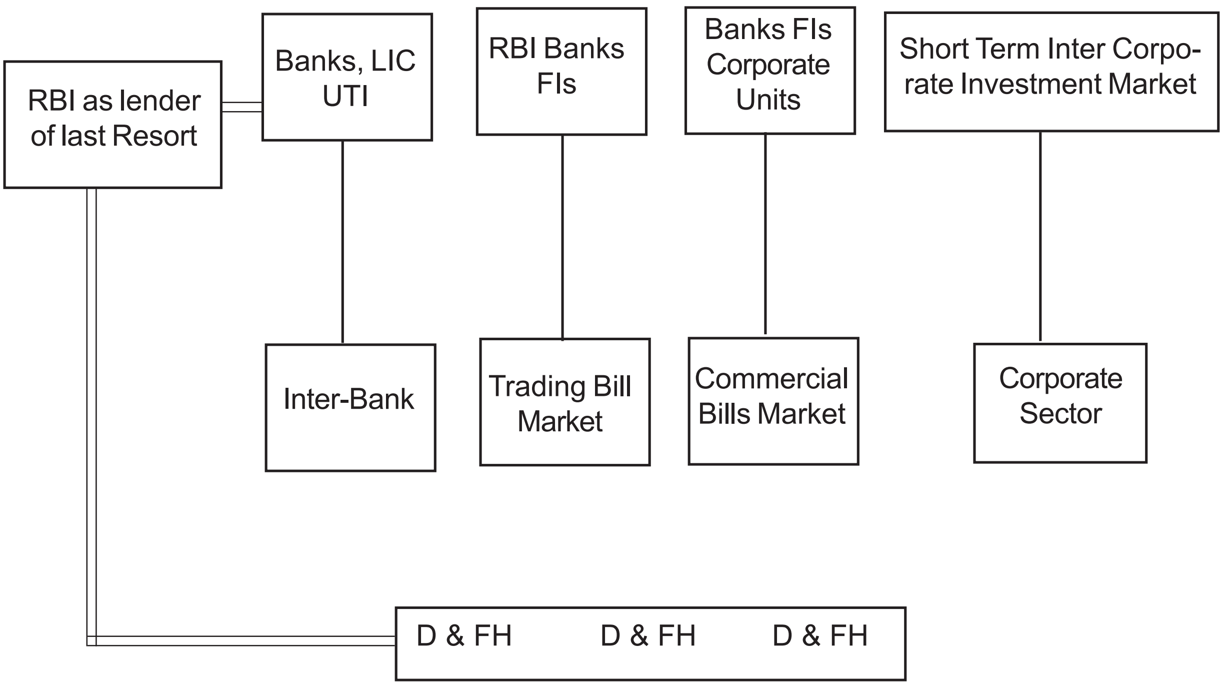
Capital market is a wider term and includes all operations in the new issues market (NIM) and stock market. It is the market in which lenders and investors provide long term funds in exchange for financial assets offered by borrowers or holders. The primary purpose of capital market is to direct the flow of savings into long term investments by development banks and other financial institutions. There are two important aspects of capital market, namely, the raising of new capital in the form of shares and debentures and trading in the securities already issued by companies. While the first aspect is much more important from the point of view of economic growth, the second aspect is also of considerable significance. However, the financial deregulation, development of new instruments of money market and setting up of new subsidiaries of banks for undertaking financial services have all aided in the deepening and widening of the capital market in India.

## 1.4 Participants in Financial Markets:

Financial Markets include money and capital markets. Money market an important segment of the financial market has no geographical constraints and relates to all dealings in money and monetary assets. The Indian money market is divided into organised and unorganised markets. The unorganised money market consists of indigenous bankers and money lenders. The organised money market in India consists of Reserve Bank of India, State Bank of India and its subsidiaries, commercial banks, foreign banks, cooperative banks, regional rural banks, financial corporations, bill market etc; The banking system is the most dominant force in the Indian money market and the RBI being the central bank occupies the pivotal position in the money market as it has wide powers to control money and credit through various credit instruments.

### Participants in Money Market:

The participants and interconnecting participants in money market are presented in the charts given hereunder.

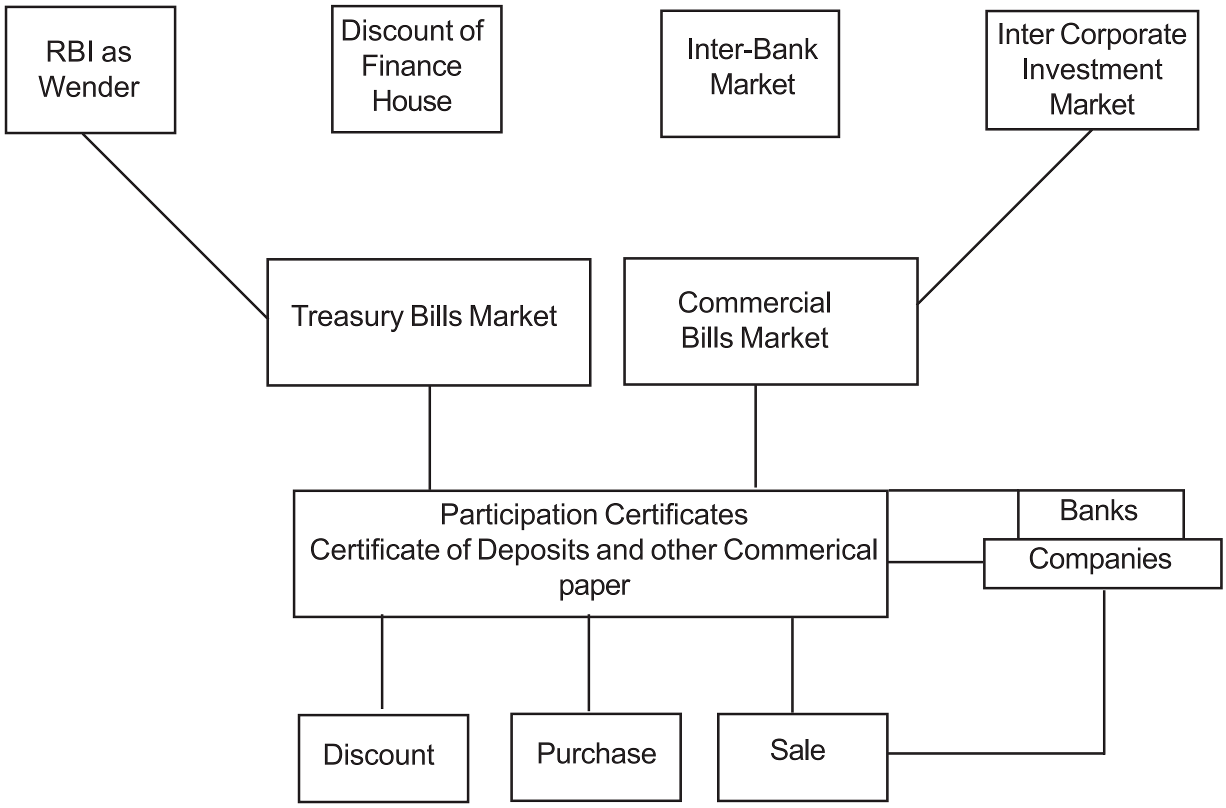



D & FH - Discount and Finance Houses

**Source:** VA Avadhani, Marketing of Financial Services, Himalaya Publishing House, New Delhi, 2004, P-42.

**Inter Connecting**

**Participants in Money market**




**Source:** V,.A, Avadhani, Marketing of Financial Services, Himalaya Publishing House, New Delhi, 2004, P- 42

The money market consists of a number of interrelated sub markets such as call marker, bill market, treasury bill market, commercial paper market, certificates of deposit market etc.

**Participants in the Capital Market:**

Following are the participants in the capital market.

* Industrial Development Bank of India (IDBI) as Apex body
* Industrial Finance Corporation of India (IFCI)
* Industrial Credit & Instrument Corporation of India (ICICI)
* Small Industries Development Bank of India (SIDBI)
* Industrial Reconstruction Bank of India
* State Financial Corporations.
* State Industrial Development Corporations

* Life Insurance Corporation of India (LIC)
* General Insurance Corporation (GIC)
* Unit Trust of India (UTI)
* Discount and Finance House of India (DFHI)
* Securities and Exchange Board of India (SEBI)
* Stock Holding Corporation of India (SHCI)
* National Stock Exchange of India (NSE)
* Over the counter Exchange of India (OTCEI)
* Credit Rating Institutions.

The Indian capital market has developed to a large extent due to various measures taken over the years. Various institutions like SEBI, Stock Holding Corporation of India, over the Counter Exchange of India and credit rating agencies have been set up to strengthen and expand the securities market in the country and to provide various services to the investors and companies and also to regulate stock exchanges so as to promote a healthy and orderly securities market. A depository system has been introduced and dematerialised trading is picking up and computerised one line trading between different markets is gathering momentum. All these steps are aimed to achieve greater autonomy to corporates and better transparency for investors.

### Financial Services:

**Concept:** Financial Services Sector refers to that sector which provides are facilities for the people to put their money in various investment portfolios. There has been phenomenal growth in the financial services sector during the last one decade. The growth of capital and money markets and the fast pace of industrialisation have contributed to the development of financial services sector to a greater extent. Financial services sector comprises financial institutions, commercial banks, merchant bankers, brokerage houses and stock advisers. The expansion of financial services at a very fast pace has left its impact on the financial services scenario in the country. In the last fifteen years, coordinated efforts were being made to reorganise and restructure the financial services industry. Such efforts were made by various committees set up by the government to look into specific area of the financial sector. Prominent among these have been the Narasimham Committee on financial sector reforms, the Pherwani Committee on reorganisation of stock exchanges, the Dave Committee on mutual funds etc.

### Elements of Financial Services Sector:

The financial services sector consists of three major elements:

**(a) Instruments:** which include issue of company shares, debentures, fixed deposit certificates, Commercial papers etc.

**(b) Market Players:** Which include Banks, financial institutions, mutual funds, stock brokers etc.

**(c) Regulatory Bodies and Specialised agencies :** Which include the SEBI, Stock exchanges, credit rating services, DFHI, SHCI, OTCE of India, Venture Capital companies etc;

**Constituents of Financial Services Sector:** Following are the various constituents of financial services sector in India.

**1) Government:** The central government is one of the most important constituents of the financial services sector because of its regulating powers. It has extensive powers under the companies Act 1956, Capital Issues (control) Act and securities contract (Regulation) Act 1956.

**2) Regulatory Agencies:**

* SEBI - Securities Exchange Board of India
* CCI - Controller of Capital Issues
* RBI - Reserve Bank of India.

**3) Financial Institutions:**

* Commercial Banks
* Mutual Funds
* Stock Exchanges
* Merchant Bankers
* Portfolio Managers
* Stock Brokers
* Non Banking Financial Institutions (NBFI)
* Financial Consultants

**4) Specialised Institutions:**

* Discount and Finance House of India (DFHI)
* Stock Holding Corporation of India (SHCI)
* Over the Counter Exchange of India (OTCEI)
* Credit Rating Information Services of India Ltd. (CRISIL)
* Information and Investment Credit Rating Associates (IICRA)

## 1.5 Nature and Scope of Financial Services:

The nature and scope of financial services are very broad which cover not only the fund based activities are: Mutual funds, Merchant Banking etc; Financial Services industry includes all kinds of organisations which intermediate and facilitate financial transactions of both individuals and corporate customers. In view of the development of industry and trade in the country, the financial services sector had to introduce numerous services in recent years to cater to the requirements of the industry. Following are different types of financial activities/services provided by various financial agencies to suit different financial needs of the country.

### 1.5.1 Mutual Funds:

Mutual Fund is an institution which pools the savings of the community and invests in various types of securities. Mutual fund units are investment vehicles that provide a means of participation in the stock market for people who have neither the time, nor the money, nor perhaps the expertise to undertake direct investment in equities successfully. It offers the individual saver the advantages of reasonable dividend and capital appreciation coupled with safety and liquidity. The first mutual fund institution i.e., Unit Trust of India was set up in 1964. Later in nineties, many public sector banks like SBI, Indian Bank, Bank of India, PNB, Canara Bank etc; and LIC GIC have launched mutual funds. Subsequently, foreign mutual funds like ANG Grindlays, Standard chartered and Private Sector mutual funds like Reliance, HDFC, ING Vysya, Tata Birla, Escorts etc; companies have started their mutual fund agencies to mobilise resources in the country.

### 1.5.2 Merchant Banking:

Merchant Bank is defined as a kind of financial institution that provides variety of services including investments, portfolio management, Corporate Counselling, under writing of the issue etc;. Merchant banking in India is of recent origin. It has its beginning in India in 1967 when Grindlays Bank established a division followed by Citi Bank in 1970. State bank of India started its Merchant Banking Division in 1972. Later on ICICI set up their merchant banking division followed by many nationalised banks and financial institutions. Some private companies have also launched Merchant banking Consultancy Services in a big way. For example, J.M. Financial Consultants Champaklal Investments and Financial consultancy, V.B. Desai Consultancy etc;. Following are the merchant banking services.

* Project Counselling or Reinvestment Studies for investors
* Syndication of Loans and Project Finance.
* Issue Management
* Provision of Working Capital
* Foreign Currency Loans
* Portfolio Management for Non Residents

### 1.5.3 Hire Purchase Financing:

Hire purchase is a form of credit where goods are supplied after payment of a deposit with an agreement to pay regular installments over a period of time. At the end of the hiring period, legal title passes to the hirer on payment of a nominal sum. The hire purchase Act was enacted in 1972 which provides for regulating various, rights and obligations of the owner (financier) and the hirer under a hire purchase transaction. Commercial banks entered in the field of hire purchase later than the private hire purchase financiers. Ever since nationalisation of bank, commercial banks have been playing a dominant role in providing finance to road transport sector, which is a priority sector for the purpose of their advances, while at the same time, hire purchase companies in the private sector continued to grow because of the fast efficient and personalised services.

### 1.5.4 Housing Finance:

Housing in India has been one of the important economic activities which serves to fulfil many of the plan objectives, providing shelter to the needy, raising the quality of life, creating additional employment. Further, housing could lead to the generation of additional savings at all levels. Easy access to institutional finance at affordable rates is an essential pre-requisite for accelerating the tempo of housing activity. In the recent past, several private housing finance companies were set up. The national Housing Bank (NHB) has been set up by the government of India as an apex housing finance body to make funds available to provide refinance the commercial banks, housing finance companies, cooperative housing housing finance companies etc; The NHB has recognised 10 housing finance companies as being eligible for refinance facilities. The Housing and Urban Development Corporation (HUDCO), Housing Development Finance Corporation (HDFC), LIC and GIC have been very active in providing finance for housing facilities.

### 1.5.5 Venture Capital:

Venture capital is a new financial service, the emergence of which went towards developing strategies to help a new class of new entrepreneurs to translate their business ideas into realities. The capital provided to start a venture is known as venture capital. In particular, for a small entrepreneur with zeal and dynamism but inadequate or lack of finance, venture capital of seed capital is a boom making it a launching pad for financial growth. Venture capital is "equity support to fund new concepts that involve a higher risk and at the same time have high growth and profit potential". Venture capital carries a high degree of risk, but the potential to generate a substantial rate of return is high, if the project is viable.

The venture capital was originated in USA during the nineteenth and early twentieth centuries. In 1987, the government of India announced guidelines for venture capital companies. In 1988, the first venture capital Company Technology Development and Information Company of India (TDICI) was jointly set up by UTI and ICICI. The Technology Development Fund (TDF) set up by IDBI, the Equity Development Scheme (EDS) set up by SBI Capital Markets Ltd and Canfina which have been joined by India Investment Fund (IIF) Promoted by Grindlays Bank are some of the venture capital institutions set up in India. In the Private Sector, Credit Capital Corporation (CCC) started a venture capital company. Andhra Pradesh Industrial Development Corporation (APIDC) and Gujarat Industrial Development Corporation (GIDC) too have started venture capital subsidiaries.

### 1.5.6 Portfolio Services:

A new area in which financial services are rendered is portfolio services i.e., managing the portfolios of individuals clients. SBI Personal Banking centres and Vysya Bank's investors clubs are the two good examples. These are also a few private investment advisers, who guide and help individual investors and manage their portfolios. Portfolio Management service include:

* Guidance on purchase and sale of securities
* Handling of such transactions
* Advise on market conditions
* Safe custody of Documents
* Collection of earnings and dividends etc;

## 1.6 Leasing Finance:

A Lease is defined as a contract between lessor and a lessee for the hire of a specific asset for a specified period of payment and for a specified rentals. It is an arrangement between two parties, the leasing company and the user, whereby the former arranges to buy capital equipment for the use of latter in accordance with the latter's requirements and specifications. The consideration for the transaction is in the form of rentals paid by the lesser to the lessor, who, however, remains the owner of the equipment over the agreed period. The rentals are predetermined and payable at fixed intervals of time, according to the mutual convenience of both the parties. A lese is a finance lease if it transfers substantially all the risks and rewards incident to ownership. Lease rentals refer the payments in the form of interest on the lessor's investment, charges born by the lessor - repairs, insurance, maintenance etc; depreciation and servicing charges.

**Types of Leases:** Following are the different types of leases:

* Financial Lease
* Operating Lease
* Sale and Lease Back Leasing
* Cross Border Lease
* Leveraged Lease
* Specialised Service Lease
* Foreign to Foreign Lease

Leasing finance business was grown in countries like South Korea, Malaysia and Indonesia and leasing is successful in these countries in mobilising and allocating scare financial resources, while fulfilling the medium term and long term needs of their rapidly growing industry. In India, the first leasing company was promoted by chidambaram group in 1973 at Madras. This was followed by the 20th century leasing company in 1980 at Mumbai. Four other finance companies ie; Shetly Investment and Finance, Motor and General Finance, Jayabharati Credit and Finance and Sundaram Finance joined the stream in 1982. The number of leasing firms in India is about 4000, Equipment leasing was being carried out by ICICI and IFCI which provide leasing for computerisation, exports, expansion etc.

Leasing finance being helpful for the small and medium sized units has gained importance with the increasing number of entrepreneurs. Leasing is accepted as an alternative source of finance. The new industrial policy and other economic measures of the government, withdrawal of investment allowance etc, have made leasing as a financing option. It plays an important role in the financing of machinery, plant and equipment. Thus, alot of optimism has been brought about in the leasing industry due to liberalisation. The need of the hour is to regulate it properly to maximise its benefits to the stake holders. Development banks' participation would bring respectability and stability in the lease market as a result of which lease finance will be widely accepted as an innovative instrument for the growth of entrepreneurship.

### 1.6.1 Factoring:

Factoring is defined as an out right purchase of credit approved accounts receivable with the factor assuming bad debt losses. With the increase in the volume of production and sales, timely collection and efficient management of receivables has assumed greater importance. Factoring Companies specialise in financing inventories and receivables. Factoring offers a clear solution to the problems created by working capital setting locked up in trade debts. It basically means purchase of book debts of clients. In order to be an economically viable proposition, a factoring agency has to build up a suitable infrastructure so as to ensure optimum efficiency in the working of credit and collection departments so that the fixed costs are absorbed at low unit costs.

Factoring is thus an asset based method of financing as well as a specialised service being the purchase of book debts of a company by the factor, thus releasing the capital tied up in accounts receivables and providing financial accommodation to the company. The factor is an intermediary between the supplier and customers who performs financing and debt collection services. Factoring in one form or other is extended on a large scale in USA, UK and many European countries. The varied services provided by the factors could benefit the large number of suppliers in India. The need for factoring in India arises due to the limitations of the banking industry in the provision of finance, credit protection or collection services. Moreover, an efficient system of receivables management for the manufacturers is the need of the hour.

The RBI has already accepted the recommendations of Kalyana Sundaram Committee and initiated on working out the details. SBI has floated its subsidiary to look after factoring service in five zones of the country. Canara Bank has also floated a subsidiary in the southern region. Private sector is being presently kept out of the factoring services. The establishment of SBI factors and Commercial Services (P) Ltd. is a boom to Indian industries. It was set up by SBI in collaboration with Small Industries Development Bank of India (SIDBI), Union Bank of India and State Bank of Saurashtra in Feb 1991 to service the industry. Since the establishment of SBI Factors and Commercial Services (P) Ltd, the sellers of the industrial products, particularly the manufacturers have improved their cash flows through prepayment facilities, leading to increased sales, continuity of suppliers and reduction in the cost of maintenance.

### 1.6.2 Forfaiting:

Forfaiting is a financial tool to exporters enabling them to convert their credit sales into cash sales by discounting their receivables with an agency called A Forfaiter. It is also to work as Risk Management tool to exporters because by selling the export receivables to the forfaiter, the exporter is relieved of the political and commercial risks involved in international trade. Forfaiting is a source of finance which enables exporters to get funds from the institution called forfaiter on transferring the right to recover the debts from the importer. The exporter surrenders his right to receive payments in future for immediate cash payments.

Forfaiting is a mechanism of financing exports carried as below:

* by discounting export receivables
* evidenced by bills of exchange or Promissory notes
* without recourse to the seller
* carrying medium to long term maturities
* on a fixed rate basis

Forfaiting is the non recourse discounting of export receivables. The most outstanding benefit of forfaiting is its flexibility and it is gaining popularity because of limitations of the traditional sources of export finance. Finance for exports needs to be fast, cheap and flexible and on all these counts, forfaiting meets the bill. Over a period of time, forfaiting is likely to emerge as an alternative source of trade finance especially for deferred exports.

## 1.7 Credit Rating Services:

Credit Rating is essentially giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of a debt instrument to meet the debt servicing obligation in time and in full. It is important to note that the company is not rated but the instrument, issued by the company is rated for its capacity to service that instrument. Credit rating is an assessment of the capacity of an issuer of debt security by an independent agency. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and it assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument through out the duration of the instrument. The methodology involved is the analysis of past performance of the company and assessment of its prospects. If debt securities are rated professionally and if such ratings enjoy widespread investor acceptance and confidence, a more rational risk return trade off would be established in the capital market.

The ratings are expressed in code numbers which can easily be comprehended even by the lay investors. The ratings are the quickest way of understanding a company's financial standing without going into the complicated financial reports. Credit rating is only a guidance to the investors and not a recommendation to a particular debt instrument. Credit rating is a source of cost information to investors. The collection, processing and analysis of relevant information is done by a specialised agency which a group of investors can trust. A highly rated firm can enter the market with great confidence. It also forewarns the management of the perception of risk in the market. Ratings also encourage discipline among corporate borrowers to improve their financial structure and performance to obtain better rating for their instruments.

The credit rating concept was started in USA in 1860. Subsequently, many countries have evolved the credit rating of corporate firms. The Indian capital market has witnessed a tremendous growth in late 80s and the member of companies borrowings directly from capital market has increased and this has forced the industry for credit rating mechanism of the debt instruments issued. Now, there are four credit rating agencies working in India: (1) Credit Rating Information Services Ltd. (CRISIL-1988), (2) Investment Information and Credit Rating Agency of India (ICRA - 1991), (3) Credit Analysis and Research (CARE - 1993), (4) Duff Phelps Credit Rating Pvt. Ltd. (DCR - India). Credit Rating agencies conduct a rating exercise at the request of a company. In accordance with industry prace allover the world, the methodology involves an analysis of the past performance of the company and assessment of its prospects. Already, more instruments and bonds of banks and corporate companies have been covered under credit rating. The outlook for the credit rating industry is said to be positive.

## 1.8 Summary:

The financial services sector in India is in a process of rapid transformation particularly after the introduction of reforms in the financial sector. The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. At present, numerous new financial intermediaries have started functioning with a view to extending multifashions services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies have transformed the financial services sector from being a conservative industry to a very dynamic one. Further, the process of globalisation has paved the way for the entry of innovative and sophisticated financial products into our country. Keeping in view of the changed environment, the financial services industry in India has to play a very positive and dynamic role in the years to come by offering many innovative products to suit the varied requirements of the millions of the prospective investors spread throughout the country.

## 1.9 Self Assessment Questions:

1. What is financial system and explain its structure.
2. Discuss the objectives and role of Financial System.
3. Examine the concept of Financial Markets and explain their participants.
4. What are financial services and describe on the elements of Financial Service Sector.
5. Outline the Nature and Scope of Financial Services and discuss Mutual Funds and Housing Finance.
6. Write short notes on:
    a. Leasing Finance
    b. Factoring
    c. Credit Rating Services.

## 1.10 Reference Books:

1. *Financial Markets And Services* : Gordon E & Natarajan K, Himalaya Publishing House, Mumbai, 2000.

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3. *The Indian Financial System* : Vasant Desai, Himalaya Publishing House, Mumbai, 1999.

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