

# [Money: bank and funds](https://assignbuster.com/money-bank-and-funds/)

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“ Money” is a fascinating object. The process of creating money and using money has always generated enthusiasm amongst mankind for over thousands of years. The main reasons for such enthusiasm are built around the dynamics of the above process. Even more fascinating is the fact, that this process is perhaps the only subject that is foxing both the pundits and the commoners alike. Such being the importance of money, any narration regarding the process shall always provide enough excitement. Keeping this in view, the role and importance of financial intermediaries is being featured for the benefit of readers.

A glimpse of this coverage is provided in the following pages to lead them to a wider canvas. Financial Intermediaries Financial intermediaries play a vital role in building economies. World over, in different economies it is typical to find that the sources of funds and the uses of funds are not one and the same. This process is also so complexly structured that while individual contributions comprise the major source of funds to the market, the utilization of funds is done by different sectors in the economy. Capital formation comprising of Savings and Investment holds the key to this process.

In this causal sequence, Savings play the role of the initiator. The ability of an economy to generate savings depends on the combined abilities of the general public and the government. It is here that the financial system comes into play by converting the savings into productive results. Significance of Financial Intermediation The savings process is facilitated by the financial Intermediaries. In simple terms, financial intermediaries perform the function of facilitating supply of funds to the user of funds, by obtaining the same from the depositors or savers of funds.

The term ‘ financial intermediaries’ includes different institutions like Banks, Insurance companies, Investment companies, Developmental Financial Institutions, Non-bankingFinanceCompanies, Mutual funds, Pension funds etc. While the role of above institutions is singular withrespectto financial intermediation, the functions that are performed by each one of them are different. In a nutshell, these types of intermediation revolve around liquidity position of funds, risks in loans, and pooling of risks to take advantage of economies of scale.

To sum up, the function of financial intermediation has arisen out of the need on the part of savers to reach the investors and the inability of investors to find savers. Developed economic systems may not require the need of full-fledged financial intermediaries, unlike the developing systems. This is due to the fact that the gap between the saver and the investor is absolutely minimal. This is referred to as “ financial disintermediation”. The process of financial disintermediation is best achieved by reducing the cost of funds thereby facilitating direct capital formation, which spurs economic growth.

The greatest advantage in this process is the fact that it reduces the time gap between saving of money and utilization. The process of financial intermediation is always fraught with risks. Risks both for the givers of funds and the takers of funds, besides the risks for financial intermediaries themselves. The risk factor arises in the first place out of the need for the availability of information and in the second place the need for players to be aware of the available information. Consequently, the need for regulations and the role for a regulator are felt.

Financial Intermediation in Indian context In India, without exception, a single type of intermediary does not perform the task of financial intermediation. Different types of financial intermediaries exist and their functions are discussed below. Banks: Banks comprise the oldest form of financial intermediaries in India. The Indian financial scene is dotted with a number of banking institutions. All these banks are segregated into various categories. This segregation has been done on the basis of their incorporation and the businesses performed by them.

Consequently, we have various kinds of banking institutions. These are: i. Commercial banks, ii. Regional Rural Banks, iii. Local Area Banks, iv. Co-operative banks. The above classification suggests that banks have been divided under various types depending on the need to achieve the different economic objectives. While making the above classification, geographical factors, need for sectoral deployment of funds involving allocation of funds for Agriculture, Industry, and Service sector etc. have been taken into consideration.

However, gradually, the needs of industrial sector have become so huge and complex that separate institutions have been set up for farming the industrial sector. Development Financial Institutions (DFIs): Deployment of funds in the Industrial sector is a major challenge. Industry’s requirements vary depending upon their short-term and long-term needs. The activities of short-term lending and long-term lending are separate and specialized functions. After understanding this finer aspect, the Government of India took initiative to set up specialized institutions for this purpose.

For this reason, we find that most of the DFIs - such as the Industrial Development Bank of India (IDBI), are statutorily formed. These institutions provide finances for most of the greenfield projects in the Indian economy and have made a significant contribution by way of financing long –term projects. It is significant to note here that DFIs have been influenced by the changes in the Indian banking scenario to such an extent that these institutions are conlemplating to become universal banks. Insurance Companies: The path of reformation in the Banking industry has also caught up with the other intermediaries as well.

In this respect, Insurance industry is witnessing path-breaking changes. In fact, in many countries Insurance companies perform a leading role as financial intermediaries. In India, Life Insurance Corporation of India (LIC) continues to play a very vital role in mobilizing savings and delivering Insurance, though the industry is experiencing the competition from players both Indian and Foreign. With the entry of banks into the arena of insurance business it is interesting to find the beneficial impact of convergence of banking and insurance business.

Non-Banking Finance Companies (NBFC): The process of Intermediation virtually begins at home, with the household sector. This sector is the basic source of funds for the intermediaries. Such being the important role of the households, NBFCs as independent institutions, have come into existence to meet their financial requirements. The services offered by the NBFCs cater to the whole gamut of needs of the household sector in particular and savers in general. \* Emerging Disintermediation in India\*\* With a rapid growth in the intermediation process, the need for financial disintermediation at some stage cannot be overlooked.

Realizing fully well that developed systems find lesser need for financial intermediation, in the Indian context the policy reforms aimed at encouraging free market institutions have been moving the financial markets towards disintermediation. The onset of the process of economic liberalization in 1991 has brought about a sea change in the financial markets. The abolition of the office of Controller of Capital Issues (CCI) and the establishment of Securities and Exchange Board of India (SEBI) in 1992 was done essentially with a view to giving an impetus to the capital markets.

The market happenings in 1992-94, did strike a hard blow to this mechanism. During the past three years the process of consolidation has begun. Though a reduction in the number of IPOs does suggest to a slackening of the Capital markets, there is also a brighter side of investors becoming more suave. Sources of Funds A discussion on financial intermediaries has to begin with the ‘ raw material’ for this activity, i. e. funds. Financial intermediaries are required to raise funds in order to fulfill the needs of both fund-based and non fund-based activities.

Considering the various sources and choices available, the financial intermediary considers the following variables in deciding about the ways and means of raising funds. These are: Maturity, Cost of funds, Tax implications, Regulatory framework and Market conditions. Maturity is vital since the intermediary has to plan for the repayment of debt. Since investors look for returns as against the intermediary looking for good spread and income, Cost of funds turns out to be crucial.

Tax treatment on returns on some of the instruments could be different – with certain exemptions Thus, Tax implications are useful for tax planning for both the intermediary and the saver. The instruments have to fulfill a plethora of rules and regulations which require the knowledge of Regulatory framework. For designing a particular type of instrument knowledge of Market conditions is essential. Different Sources of Funds In addition to providing low-cost funds, the shareholder route is a popular and easy way for the common public to become ‘ owners’ of companies.

As the name suggests, the money belongs to the shareholders. Financial institutions have been innovating different methods for raising money from the prospective shareholders. ‘ Reserves’ is another source of funds. Incidentally, it is to be known that some of the Reserves are created statutorily. Borrowing by a company is another source of funds for the company, which are repayable with interest. Unlike equity, the funds raised by way of loans are to be repaid. \*\* \*\*Sources of Funds unique to a Bank The previous classification of sources of funds does not fully explain the avenues for Banks.

By virtue of being one of the earliest financial intermediaries, and possibly the most prudent as well, banks have a privileged access to a few more instruments. Considering the fact that different types of financial intermediaries have accessibility to varied types of funds at different rates of interest, it has become necessary for the RBI to lay down norms in this regard. Financial Intermediaries look towards liquidity in the market for enhancing their scope of operations. However, liquidity is a double-edged knife.

Excess liquidity or lack of liquidity affects the financial system resulting in either a reduction or an increase in the rate of interest. The cyclical effect is felt by the economy. For controlling liquidity levels in the economy, RBI exercises control through the mechanisms of CRR and SLR. CRR is the reserve to be maintained by banks with the RBI. SLR is the reserve that is maintained by banks for investment in cash, gold or unencumbered approved securities. Deposits The customers’ confidence level reflects the strength of a bank. There is no better way of reflecting the same by any other indicator than Deposits.

In the wake ofglobalization, the avenues for banks for raising funds in the capital market have increased, both in the national and international markets. In terms of value to the Banking system, banks that have a greater deposit base have more value than the banks with a poor deposit base. Banks accept deposits in different ways. Such acceptance could be different in terms of the period, amount, rate of interest and the type of depositor. All the deposit accounts could be classified under Transaction accounts and Non-transaction accounts. The types of accounts that a customer – individually, jointly or corporate can have, are varied.

Having said that Deposits are an important source of funds for the banks, a banker is wary about the types of deposits. A term deposit is a dependable source, but the cost is higher than Demand deposits that are low cost funds for the banks. Consequently, the composition of deposits has a direct impact on the profitability of the bank. Application of Funds The real challenge for the financial intermediaries begins at the very end of the first stage i. e. after mobilization of deposits. The meter virtually starts ticking from that time onwards since the deposits are to be repaid by the bank to the customer after a certain period with interest.

In order to honor this commitment, financial intermediaries use their funds in different ways. Broadly, the purposes under which they are used can be classified under: i. loans and advances, ii. investments, iii. fixed assets. Loans “ Loan” is a distinct activity wherein funds are taken from the saver and given to the investor. By nationalizing major banks in 1969 and 1980 Government of India sought to direct the utilization of bank funds for socially disired, objectives reflected in priority sector lending.

Priority sector lending includes Agriculture and Small Scale Industry as focus areas that would promote equitable development of regions and promote employment avenues. Loans can be classified as secured loans and unsecured loans based on the availability of security or otherwise. Investments The best way to earn attractive return on money is by following an Investment strategy. Since banks have to service their borrowings and deposits at a reasonably good rate and put the funds into more profitable use, Investments in securities offer an option, though in many instances, this is a statutory requirement.

There are three main reasons for the Banks to invest in government securities. These are: (i) in case need arises; government securities meet the liquidity requirements of a bank; (ii) it forms a second line of security, for emergency borrowing from RBI, and (iii) for meeting statutory SLR requirements, aimed at protecting the interests of depositor. Banks are also selectively restricted from investing in equity shares. Investments are made in equity shares either through primary issue or by secondary market. Investment initiatives in equity by banks are expected to boost a sagging capital market.

Apart from the primary functions of deposit collection and lending, banks also perform treasury operations. The necessity arises out of liquidity compulsions in operations. Banks invest in bonds and debentures as a part of their regular treasury operations and also on behalf of customers. Fixed assets however, constitute a very small amount of investment by banks. The Management of Financial institutions revolves around two basic functions: i. the ability of the intermediary to raise funds, and ii. to deploy them. These two activities determine the sustenance as well as profitability of the intermediaries.

Lending Function Apart from the fact that Lending constitutes the major source of income for the bank, the process of lending also depends on the bankers’ appraisal skills. The banks’ funds can be applied in two major areas i. e. investments in securities and credit accommodation. In the process, banks essentially look to balance the ‘ spreads’. Apart from the necessity of complying with the regulatory prescriptions, requirement of profitability virtually forces banks to develop an organized credit deployment mechanism. The credit policy of banks is determined by the demand and supply of loanable funds of banks.

Firstly, on the demand side of the economy there are the consumers of goods and services. Secondly, the need for credit comes from the corporate sector in the manufacturing, trading and services sectors. Credit management is a specialized area. This is due to the fact that there are different types of credit, and each type of credit is characterized by certain unique factors. Loan is a broad term used to explain the different types of credit facilities - short/medium term extended in the credit market. The selection of the type of loan by a borrower depends on three factors namely, need for credit, cost factor, and cash flow requirements.

Since a loan has a demand side and supply side as well, loans can be classified accordingly. Demand side loans will be individual loans while Supply side loans can be classified as commercial loans. As in the case of a borrower, for the bank, providing the loans depends on three factors, namely the nature of credit, the type of security and the purpose of loan. Based on these parameters, further classification of the banks’ advances is done. Loans are also further classified under secured and unsecured loans. Banks have been providing advances to different sectors of the economy and at the same time providing loans to the needy sectors.

The sectoral classification of bank loans is made as under: i. priority sector, ii. public sector, iii. banking sector, and iv. others. Loan Appraisal and Disbursal Preliminary appraisal involves an analysis of the market, technology, financial, and managerial skills of borrowing. Once the bank decides to finance, other critical issues are the decisions relating to the mode of financing. Finance is given for land, site development, building, plant and machinery and also for working capital. Banks arrive at the amount of Maximum Permissible Bank Finance (MPBF) through various appraisal methods. \*\*Non-fund Based Services\*

Non-fund based Services Non-fund based advances in the form of: Letters of Credit and Guarantees offer a very attractive proposition to the banker. Since funds disbursement arises only on default or the happening or non-happening of an event, bank holds only contingent liability. Payments and clearing operations Clearing and remittences constitute important services under ancillary services. The major role of a bank involves mobilizing savings and channelizing them into investments. Complementing these activities are ancillary services of the banks which facilitate the entire payment and settlement system of financial transactions