# UNIT 3 FINANCIAL SERVICES : AN INTRODUCTION

## Objectives

After reading this unit, you should be in a position to:

- explain the concept and meaning of financial services;
- discuss the significance of financial services;
- describe the various types of financial services;
- explain the impact of technology on the financial services sector; and
- enumerate the challenges before the financial services sector.

## Structure



## 3.1 INTRODUCTION

The financial system is a very complex system dealing with a vast variety of financial activities. The financial system consists of Financial Institutions, Financial Markets, Financial Instruments and the Financial Services. The first component of the Financial System, i.e. the Financial Markets, has been discussed in the first unit.

Financial Markets and Financial Institutions facilitate the functioning of the Financial System through Financial Instruments. The financial markets play a very significant role as far as the transfer of funds (financial assets) from surplus units to deficit units is concerned. This transfer of funds from lenders to borrowers is facilitated by banks and non-banking institutions, as well as various other agencies participating in the market. In unit 2, we have already studied about the major participants in the Money Market and the Capital Market.

Financial Services, the fourth component of the financial system around which this particular course revolves, is a very popular area for study these days. It is rather, highly diverse functional area requiring a great degree of competence and knowledge in a wide range of relevant disciplines. However, in this unit we will be briefly discussing about the various aspects of the financial services and also the challenges this sector is posed with.

## 3.2 MEANING AND CONCEPT

The Financial Services Sector *per se* has become known in the past 25-30 years, although the concept of financial services has been in existence since times immemorial. However, there is no straight forward defintion for the term Financial Services, but if we look at the meaning of the term 'financial services' as it is applied in UK, it could be understood to be including banking, insurance, stock broking and investment services as well as a wide range of other business and professional services. In other words, what we can say is that financial services are services that ensure the smooth flow of financial activities in the economy.

Financial services are an important component of the financial system. They cater to the needs of financial institutions, financial markets and financial instruments which are geared to serve individual and institutional investors. Financial institutions and financial markets facilitate functioning of the financial system through financial instruments. In order to fulfil the tasks assigned, they require a number of services of financial nature and hence financial services are regarded as the fourth element of the financial system. Thus, functioning of the financial system depends to a great deal on the range of financial services extended by the providers, and their efficiency and effectiveness.

Financial services include the services offered by both Asset Management Companies and the Liability Management Companies. The asset management companies are viz. leasing companies, mutual funds, merchant bankers and issue/ portfolio managers. Bill discounting houses and acceptance houses come under the liability management companies. Technological innovation and globalization has brought about a key change in the financial services sector, i.e. the convergence occurring within the sector. Similar services are now being offered by different players.

Financial services not only help to raise the required funds but also ensure their efficient deployment. They assist in deciding the financing mix and extend their services up to the stage of servicing of lenders. In order to ensure an efficient management of funds, services such as bill discounting, factoring of debtors, parking of short-term funds in the money market, e-commerce and securitisation of debts are provided by financial services firms. This sector provides services such as banking, insurance, credit rating, lease financing, factoring, venture capital, mutual funds, merchant banking, stock lending, depository services, housing finance, etc. These services are provided by various institutions like stock exchanges, specialised and general financial institutions, non-banking finance companies, subsidiaries of financial institutions, banks and insurance companies.

Financial services sector is regulated by the Securities and Exchange Board of India (SEBI), Reserve Bank of India and the Department of Banking and Insurance, Government of India, through a plethora of legislations.

## 3.3 CHARACTERISTICS OF FINANCIAL SERVICES

Financial services are quite distinct in nature from the other services. The services provided by the financial institutions have some typical characteristics that make these products quite distinct from the products turned out by the industrial enterprises. Some of the basic characteristics of financial services are as discussed :

i) **Customer-Specific :** Financial services are usually customer focussed. The firms providing these services, study the needs of their customers in detail before deciding their financial strategy, giving due regard to costs, liquidity and maturity considerations. Financial services firms continuously remain in touch with their customers, so that they can design products which can cater to the specific needs of their customers. The providers of financial services constantly carry out market surveys, so they can offer new products much ahead of need and impending legislation. Newer technologies are being used to introduce innovative, customer friendly products and services which clearly indicates that the concentration of the providers of financial services is on generating firm/customer specific services.

ii) **Intangibility :** In a highly competitive global environment brand image is very crucial. Unless the financial institutions providing financial products and services have good image, enjoying the confidence of their clients, they may not be successful. Thus institutions have to focus on the quality and innovativeness of their services to build up their credibility.

iii) **Concomitant :** Production of financial services and supply of these services have to be concomitant. Both these functions i.e. production of new and innovative financial services and supplying of these services are to be performed simultaneously.

iv) **Tendency to Perish :**Unlike any other service, financial services do tend to perish and hence cannot be stored. They have to be supplied as required by the customers. Hence financial institutions have to ensure a proper synchronization of demand and supply.

v) **People based services :** Marketing of financial services has to be people-intensive and hence its subjected to variability of performance or quality of service. The personnel in financial services organisation need to be selected on the basis of their suitability and trained properly, so that they can perform their activities efficiently and effectively.

vi) **Market Dynamics :** The market dynamics depends to a great extent, on socioeconomic changes such as disposable income, standard of living and educational changes related to the various classes of customers. Therefore financial services have to be constantly redefined and refined taking into consideration the market dynamics. The institutions providing financial services, while evolving new services could be proactive in visualising in advance what the market wants, or being reactive to the needs and wants of their customers.

## 3.4 EVOLUTION OF FINANCIAL SERVICES IN INDIA

The financial services industry in India is in the process of attaining full bloom. To reach the present position, it has passed through a number of stages as mentioned below:

### The Stage of Infancy

This existed between 1960 and 1980 and covered in its gamut merchant banking, insurance and leasing services.

Merchant Banking Services were unknown until the early 1960s. The policy makers and researchers had lack of clarity about the term "merchant bankers". Someone defined them as institutions which were acting; neither as merchants nor as bankers. However the term was used as an umbrella function, providing a wide range of services, starting from project appraisal to arranging funds from bankers. The merchant bankers are expected to identify projects, prepare feasibility reports, develop detailed project reports, and in doing so conduct marketing, managerial, financial, and technical analyses. Having done this, they are approached to garner project finance, and in order to do this resolve the problem's of capital structuring. They are asked to act as a bridge between the capital market and the fund-seeking institutions. They underwrite the issues and become subject to developments in case such issues are not fully subscribed. They assist the enterprises in getting listed on the stock exchanges. They offer legal advice on registration of companies and removing legal tangles. They provide advice and help in mergers and acquisitions. They give technical advice on leveraged - buyouts and takeovers. Recently they have added the syndication activity in their portfolio, wherein they form a syndicate or become a part of it to raise project finance. They arrange working capital loans and manage the risk element present in the form of general risk which is covered by the insurance policies of the General Insurance Company.

Investment companies such as the Unit Trust of India, the life insurance business initiated by the Life Insurance Corporation of India, and the general insurance business, also made their mark in the first stage of financial services. During this period, the Life Insurance Corporation of India has grown as a public monopoly. Prior to its setting up, the private sector was operating the life insurance business. The general insurance business was nationalised in the early 1970s. A holding company was set up with four subsidiaries to handle the general insurance business in the public sector. Suggestions were given very frequently to privatise the insurance business, as in no way could the insurance business be considered as a national monopoly.

Leasing made its mark in the closing years of the 1970s. Initially such companies were engaged in equipment lease financing. Later, they undertook leasing operations of different kinds, including financial, operating and wet leasing. During this period the number of leasing firms has shot up to a high of 400. The reorganisation of such firms due to their non-viability later led to a contraction in their numbers.

### Modern Financial Services

Financial services have entered the second rung during the later part of the 1980s. Over the counter services, share transfers, pledging of shares, mutual funds, factoring, discounting, venture capital, and credit rating, constitute some of the modern financial services. In the West, these services emerged on the scene about 100 years back. The mutual fund business is the major provider of funds to industry anywhere in the developed countries. The mutual funds there have been innovative in terms of schemes. They have been giving stable rate of return. Their asset and liability management is transparent. The small investor is secure in their hands. Their business policies are such that they create value for their investors. Investors are not victimised by shifts in valuation policies, and efforts are made to harmonise the net asset valuation. The mutual funds have their own code of conduct.

Credit rating is another important financial service which made its mark in India in the mid-1980s. Credit rating boosts investor' confidence in capital market operations and prevents fly -by-night companies from making forays in the capital market. There was one credit rating company initially and we have ended up with eight finally. In terms of spread of the credit rating function, initially only debt instruments issues were covered. However later, instruments such as commercial papers and fixed deposits were brought under the purview of credit rating. Incidentally, there is a sovereign credit rating assigned by credit rating firms for the country. The Discount and Finance House of India Limited and a number of factoring institutions, such as State Bank of India Factors and Canbank Factors Ltd. Venture capital funds made their appearance in the late 1980s, Most of these firms have been operating in the public sector.

### The Third Flush

The third flush in financial services includes the setting up of new institutions, and paving the way innovating new instruments and also their flotation.

The setting up of depositories has brought the India financial services industry in line with the global financial services industry. It has promoted the concept of paperless trading and resulted into dematerialisation of shares and bonds. The stock-lending scheme approved by the Central Government in 1997-98 budget and the setting up of a separate corporation to deal with the trading of the "Gilts" are innovative measures. The steps initiated to popularise book building in order to help both the investors and fund users. The online trading interface by the Bombay Stock Exchange, the Delhi Stock Exchange, and computerisation of the National Stock Exchange, is acting as the fulcrum for the development of financial services arid is another major advancement in the field of financial services. This has given a fillip to paperless trading, save the investors from the onslaught of jobbers and brokers, and reduce tax evasion. The guidelines from the Securities and Exchange Board of India in relation to the capital adequacy ratio for the merchant bankers and their categorisation into different groups is a major advancement. This will ensure investor protection and create a differentiation in the market place. The creation of the Securities and Exchange Board of India itself can be hailed as a path-breaking development in terms of regulation, growth, and development of financial services. The ongoing efforts to revamp the Companies Act, Income-Tax Act, etc. would also lead to the deliverance of effective financial services. The guidelines about permitting foreign financial institutions to operate in the Indian capital market will do a two-way good to the country in terms of enabling the foreign investors to plug into the Indian capital market, and the Indian investors and financial institutions to study the modus operandi of such firms.

Public enterprise disinvestment are sure to prop up the state-of-art in the realm of financial services. It would provide a fillip to the presence of foreign financial firms in India, as well as result into creating pressure on the Indian financial firms to master the disinvestment business. The financial services firms would have to gain expertise in valuation, financial and legal restructuring, and taking the public sector firms to the commercial and capital markets.

During this period financial services firms scouted for funds abroad to finance the Indian corporate sector. They have approached the European capital markets, the most prominent of which belong to the UK and Luxembourg. These portfolio investments have flowed to India through the GDR route. It requires an understanding of raising funds abroad and also working together with world level financial services institutions, such as Lehman Brothers, Arthur Anderson, and Glodman Sachs, to mention a few.

With the passage of the Insurance Regulatory and Development Authority (IRDA) Act, 1999, the Insurance Regulatory and Development Authority was set up with statutory powers to function as the regulator for the insurance sector in India. This act has opened the doors for private players including foreign equity participation upto a prescribed limit of paid up capital. It has come out with regulations on various aspects of insurance business such as licensing of agents, solvency margin for insurers, accounting norms, investment norms and registration of Indian Insurance Companies. RBI allowed banks to enter into the insurance business by issuing a notification specifying insurance as a permissible form of business under section 6(1) (o) of the Banking Regulation Act, 1949. Thus providing banks another avenue for generating fee based income.

### New Financial Instruments

The new financial instruments are both being talked about and are also being used. The critical factors governing the chemistry of the issuance of the new financial instruments relate to maturity, risk, and interest rate. Based on these, in Germany some 400 financial instruments have been innovated. In India, both the market players, such as mutual funds, banks, brokers, stock markets, and the regulators, including the Finance Ministry, the Reserve Bank of India and the regulators, and the Securities and Exchange Board of India, have to make more efforts to creat new funds and new instruments. One may like to mention in this case the very uncordial welcome given to securitisation. The housing finance companies, automobile manufacturers, and development and commercial banks can use this method greatly to their advantage. However, only a few companies have devoted their mind to the application of this method. Both the market players and the regulators have for very long been engaged in the idea of setting up the derivatives market in India. When the Indian economy is trying to become global in nature, the fluctuations in the rate of foreign exchange would be a routine matter, and hence there would be a need for currency, interest, and commodity-based derivatives. Derivatives have now become increasingly important in the field of finance. Futures and options are now traded on many exchanges. Derivative instruments such as Forward Contracts, Swaps and many others are regularly traded both in the exchanges and in the over the counter market.

## 3.5 SIGNIFICANCE OF FINANCIAL SERVICES

The financial services sector plays a very crucial and significant role in a country's economy.

### Growth and Development

The financial sector, now represents a significant proportion of the total economic activity in most economies. In most developed economies, the financial services sector has grown rapidly over the post-war period. In India, this sector has come up gradually after independence. However, after the liberalisation process initiated by the government, this sector saw a considerable growth.

When one examines the structure of most economies over the last few decades, the most striking feature is the growth of the services sector as compared to the manufacturing sector. This is well reflected in the employment statistics for the respective countries. Employment is just one of the measures of significance of each group of activities within the economy as a whole.

In UK, at the begining of 1970's the employment in services sector was 53% against 36% in the manufacturing sector, but towards the begining of 1990's it has risen to 73% whereas the employment in the manufacturing sector has gone down to 20%. Banking/Insurance/Finance, in the UK at the beginning of 1970's represented around 11% of total employment within the services sector which has risen to over 17% by the 1990's.

In India at the begining of the 1970's the employment in services sector was 6% against 9.4% in the manufacturing sector, but towards the beign of the 1990's the employment in the services sector has risen to 7.3% whereas in the manufacturing sector it was only 10%. Banking/ Insurance in India at the begining of 1970's represented 0.3% of the employment within services sector which has risen to 0.6% by the 1990's.

It may be true that technology had a stronger effect on the manufacturing sector than on the services sector during the earlier days. But it's equally true that the market for manufactured goods has tended towards saturation in the post-industrial economies whereas services have experienced an acceleration in demand for their products as income and wealth grew. Another reason for this change, in developed economies like UK could be due to shifting of the manufacturing of more standard goods from high wage economies towards developing economies with lower labour cost. In developing economies like India, however there is an increase in both the sectors, but its quite evident that the rate of growth is more in the services sector. Thus, the rate of growth of the size of the financial services sector as a proportion of the overall economy is significant.

### Role of Financial Intermediation

The financial services sector is made up of financial institutions such as banks, insurance companies, trusts, loan companies, credit unions, securities dealers and exchanges, etc. which act as financial intermediaries. Financial institutions carry out the process of financial intermediations by acting as a channel through which the financial surpluses of some groups in society (e.g. households) are collected and then distributed to other groups in society (e.g. firms) which have a deficit.

It is well known that banks perform the role of taking in deposits from customers and lending it to other customers. Similarly, the insurance companies, particularly those involved in long-term life assurance business, collect premiums from policy holders and invest these surpluses in industrial/commercial activity *via* the stock market.

The growing size of the financial activity relative to the overall economic activity in a closely integrated world has implied that disruptions in the financial markets in any economy can engender contagion which can spread rapidly and have adverse economic ramifications. So the financial intermediations role played by the financial services sector is crucially important in moblising savings for investment purposes.

### Unique Features

Financial services are unique in themselves but they do share many of the features of the products of other services. Financial services are intangible and perishable in nature. The institution providing these services may succeed only if they have a good image and confidence of the clients, and at the same time ensuring that demand & supply go hand-in-hand. The focus of these institutions has to be continuously on the quality and innovativeness of their services in order to gain the trust of their clients thereby building their credibility.

The products of the financial services sector are usually long-term in nature and hence there is a great deal of uncertainity in the mind of the customer as to whether, he had made a right choice. Owing to the nature of these products, the consumer needs to seek external advice. However, much of this advice comes from the institution itself, mostly through their agents. They usually provide advice on product suitability, quality and price either directly or via an agent/broker who is paid commission by the sellers of the services.

The functions of producing and supplying financial services have to be performed simultaneously for which there has to be a perfrect understanding beteween the financial services firms and their clients. Even the marketing of these services, needs to have, not only people-orientation, but also process-orientation. Financial services are usually customer-oriented. Financial services institutions study the needs of the customers in detail to suggest financial strategies which give due regard to costs, liquidity and maturity considerations. The providers of financial services remain in constant touch with the market offering new products much ahead of need and impending legislation. Fianancial services have to be constantly redefined and refined on the basis of socio-economic changes such as disposable income, standard of living and educational changes related to the various classes of customers. Financial services institutions while evolving new services could be proactive in visualising in advance what the markets want, or reactive to the needs and wants of customers.

**Creation of Credit**

The financial services sector particularly the banking sector is very important to the operation of the economy and to the conduct of the government economic policy. The major liability of banks is the customer's deposit, which is a significant element of the country's money supply. It is through their lending activities, that banks are able to create new bank deposits and hence the country's money supply.

Let us understand what this means with the help of a simple example. The assumption that we are making here is that cash advances are always repaid in the banking system as fresh deposits. Suppose Mr. X, who is a customer of a bank, deposits Rs. 1000 with the bank. The bank in turn lends Rs. 500 by way of cash advance to customer Y. The customer Y spends this cash, i.e. Rs. 500, with customer Z, who in turn deposits it with the banking system. Further, suppose that the bank lends you Rs. 1000 by making a loan, and crediting your current account. You, in turn, write a cheque on your account in favour of IGNOU, who deposits the cheque in its account. However, the net effect of lending is that there is no change on the overall banking system balance sheet, but the banking system now owes IGNOU Rs. 1000 rather than you. From this example, it could be seen that the banking system has thus increased its deposits and hence the money supply to 25% of its initial deposit.

This process of deposit creation continues indefinitely, but in practice, the bank needs to retain a reasonable percentage of its deposits in cash or liquid assets. We may not go into these details here, but the point that needs to be emphasized upon is that the banks through their lending activities are able to create new bank deposits and hence increase the country's money supply.

**Activity 1**

1) Try to define financial services in your own words.

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2) Name few of the financial services that you have been using.

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## 3.6 TYPES OF FINANCIAL SERVICES

Although there is no such scheme of classification of financial services which may satisfy everyone or is able to cover all the subtleties of this industry. However, in order to understand the functioning of the financial services industry in a better perspective we have tried to organize our discussion of the financial services industry by classifying the financial services under three broad categories, i.e. Fee Based Services, Fund Based Services and Insurance Services.

### Fee Based Services

Fee based financial services are those services wherein financial institutions operate in specialised fields to earn a substantial income by way of fees, dividend, commission, discount and brokerage on operations. The major fee based financial services are as follow:

a) Issue Management

b) Corporate Advisory Services

c) Credit Rating

d) Mutual Funds

e) Asset Securitisation

#### a) *Issue Management*

Issue management refers to management of securities offerings of the corporate sector to public and existing shareholders on right basis. In simple words Issue Management refers to managing issues of coporate securities like equity shares, preference shares and debentures or bonds. Issue Managers in capital market parlance are know as Merchant Bankers or Lead Managers, although the term Mercant Banking covers a wide range of services such as project counselling, portfolio management, investment counselling, mergers and acquisitions, etc. Issue Management constitutes perhaps the most important and sizeable function within it, so much so, that very often the terms Merchant Banking and Issue Management are almost used synonymously.

Issue mangement involves marketing of capital issues, of existing companies including rights issues and dilution of shares by letter of offer, merchant bankers give advice on decisions concerning size and timing of the public issue in the light of the market conditions. They also provide assistance to the corporate units on the designing of a sound structure acceptable to the financial institutions and determining the quantum and terms of the public issues of different forms of securities. Merchant Bankers also advise the issuing company whether to go for a fresh issue, additional issue, bonus issue, right issue or a combination of these. The various aspects of issue management, are dealt with in detail, in *unit* 10 of this course.

#### b) *Corporate Advisory Services*

Corporate Advisory Services are needed to ensure that a corporate enterprise runs efficiently at its maximum potential through effective management of financial and other resources. The services which come in the ambit of coporate advisory services, for a business enterprise, include services such as providing guidance in areas of diversification based on the Government's economic and licensing policies, appraising product lines and analyzing their growth and profitability, consultancy for rehabilitation of sick industrial units, advice on capital structuring and restructuring, etc. These services are usually provided by merchant bankers.

Corporate advisory services constitute an important component of the portfolio of the activities of merchant bankers. It covers any matter worth the benefit for a coporate unit involving financial aspects, governmental regulations, policy changes and business environmental reshufles, etc. Thus, the scope of the corporate advisory services is very vast ranging from managerial economics, investment and financial management to corporate laws and the related legal aspects. We have discussed at length most of the coporate advisory services in *unit* 11 of this course.

c) ***Credit Rating***

The origin of this service lies in the financial crisis of the US in 1837. The first mercantile credit rating agency was set up in New York in 1841 to rate the ability of the merchants to pay financial obligations. In India, credit rating came in much later. The first credit rating agency viz. the Credit Rating and Information Services of India Ltd. (CRISIL) was set up in 1987, followed by ICRA in 1994.

The term 'Credit Rating' comprises of two words 'credit' and 'rating'. Credit is trust in a person's ability and intention to pay or reputation of solvency and honesty. Rating means estimating worth or value of, or to assign value to classifying a person's position with reference to a particular subject matter. Rating is usually expressed in alphabetical symbols. Thus, Credit Rating can be defined as an expression of an opinion through symbols about credit quality of the issue of securities or company with reference to a particular instrument.

In India, the scope of credit rating is limited to debt instruments, i.e. debentures, bonds, fixed deposits, commercial paper, etc. However, in developed countries equity shares are also rated. Credit rating is thus an important device in the hands of investors to analyse the instruments floated by issuers. To know more about the typology of credit rating, the credit rating process, and other related issues please refer *unit* 12 of this course.

d) ***Mutual Funds***

Mutual fund is a trust that pools the savings of a number of investors who share a common goal. Thus, it offers a common man an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost. In other words, mutual funds invest the money collected from the investors, with the help of professional managers, in capital market instruments, such as shares, debenture and other securities.

Mutual fund is usually a long-term investment with a certain level of risk. Of course, the open-ended feature of mutual funds ensures that you get money whenever you want at a short notice, i.e., the scheme on behalf of the unit holders invests in securities, collects the interest payments and dividends from these securities and sell them when you need money. At the time of initial public issue investors can invest in close-ended funds, but afterwards they can either buy or sell the units of the scheme on the stock exchanges where they are listed. In some schemes there is an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices.

As per SEBI Regulations at least one of the two exit routes is to be provided to the investor. The tax-saving Equity Linked Saving Schemes (ELSS) and pension schemes give added benefit of tax rebate.

***e) Asset Securitisation***

Asset Securitisation is a process whereby loans and other receivables are packaged, underwritten and sold in the form of asset-backed securities. The assets which can be securitised include receivables from the government, trade related receivables, credit card receivables, automobile loans, real estate loans, housing loans etc. Securitisation can be defined as the process which takes place when a lending institution's assets are removed in one way or the other from the balance sheet of that lending institution and are funded instead by investors who purchase a negotiable instrument evidencing this indebtedness without recourse or with limited recourse to the original lender.

Under Asset Securitisation a financial institution pools and packages individual loans and receivables, creates securities against them, gets them rated and sells them to the investors at large through public offerings or private placements (Trustee). The asset cash flow are remitted to the trustee who in turn pays scheduled interest and principal payment to the investors. Thus, " Securitisation is a synthetic technique of converting assets into securities, securities into liquidity, liquidity into assets and assets into securities on an ongoing basis" thereby providing flexibility of yield, pricing pattern, size risks and marketability of instruments used to the advantage of both borrowers and lenders/investors.You may refer to *unit 14*. to know about the origin, process, mechanism and instruments of securitisation.

### Fund Based Services

In fund-based services the firm raises funds through equity, debt, and deposits and invests these funds in securities or lends to those who are in need of capital.

We will be discussing here some of these fund-based services such as:

a) Leasing and Hire Purchase

b) Housing Finance

c) Credit Cards

d) Venture Capital

e) Factoring

f) Forfaiting

g) Bill Discouting

a) ***Leasing and Hire Purchase***

The growth of leasing industry can be traced to the formation of First Leasing company of India in 1973 by Mr. Farouk Irani and remained the only company in the country till 1980. By 1981, a few more companies, i.e. 20th Century Finance Corporation, Shetty Investment and Finance, Jaybharat Credit and Investment, Sundaram Finance, etc. joined the leasing game. During the late 1982, numerous financial institutions and commercial banks started joining in. Since then the industry leapt into prominence and today we find it as a flourishing business.

Leasing refers to a contract under which the owner of an asset allows another person or party to use the assets in return for some rent. The owner of the asset is referred to as the 'lessor' and the person using the asset in return for a payment is referred to as the 'lessee'. However, the lessee is responsible for the maintenance of the asset. In leasing the cost of capital is usually recovered from multiple serial rentals and the final sale of the asset. All financial leases virtually fall under one of the four types of lease financing viz. capital lease, operating lease, sale and lease back and leveraged lease which are explained in detail in *unit 15*.

According to the International Finance Corporation (IFC) hire purchase is a hybrid instrument that provides an alternative to bank financing for purchasing an asset. A hier purchase involves, in essence, the purchase of an asset on the understanding that the purchaser (called the hirer) will pay in equal periodic instalments spread over a length of time. This service is usually used for financing consumer durables. Now-a-days it is more popular with automobile financing business. Leasing and hire purchase have emerged as a supplementary source of intermediate to long-term finance. These services are provided mainly by non-banking financial companies, financial institutions and other organisations.

b) ***Housing Finance***

Housing is one of the basic needs of the society. It is closely linked with the process of overall socio-economic development of a country. This sector remained neglected for quite some time. It was only in the Seventh and Eighth Five-Year Plans that it was paid heed to. However, today it is a growing industry with the banking sector evincing keen interest, which in turn could have been fueled by the lack of preferable alternative avenues for investment.

Presently, funds required per dwelling shelter are so high that the individual's saving is not adequate to meet the expenditure of house building. As a result, there is a great demand for external housing finance. To take advantage of this situation, the lending institutions are competing with each other for a market share by offering very attractive terms to the customers in the form of lower rate of interest, liberal collateral requirements, longer payment period etc. These institutions have also introduced the floating rate products besides the fixed rate ones, with the option made available to the borrower for conversion against a nominal payment. The other tactics of market acquisition are speedier processing and disbursement, efficient advisory services, waiver or reductions in associated up front fees etc. In *unit 16,* we have explained the role of National Housing Bank in housing finance. We have also discussed therein the housing finance schemes offered by various housing finance institutions.

***c) Credit Cards***

Credit cards generally known as plastic money, is widely used by consumers all around the world. The convenience and safety factors add value to these cards. The changes in the consumer behaviour led to the growth of credit cards. It is a document that can be used for purchase of all kinds of goods and services in the world. Credit card identifies its owner as one who is entitled to purchase things without cash, purchase services without money and be eligible to get credit from a number of establishments.

The card issuer issues credit cards depending on the credibility of the customers. The card issuer also enters into a tie-up with merchant establishments which are engaged in various fields of business activities. The issuer for its convenience and for proper scrutiny sets up a credit limit for its card holders and a floor limit for its merchant establishments. The credit card offers the individual an opportunity to buy rail/air tickets, makes purchases from shops and stay at hotels when they need.

Credit card is a card which enables an individual to purchase certain products/ services without paying immediately. He needs to only present the credit card at the cash counter and has to sign some forms. In short he can make purchase against credit card without making immediate cash payment. Therefore credit cards can be considered as a good substitute for cash and cheques. In order to know the details of this financial service, you may go through the unit on credit cards *(Unit 17).*

d) ***Venture Capital***

The concept of Venture Capital was introduced in India by the all India Financial Institutions with the inauguration of Risk Capital Foundation (RCF) sponsored by the Industrial Finance Corporation of India (IFCI) to supplement promoters equity, with a view to encouraging technologists and professionals to promote new industries. Venture capital implies long-term investment generally in high risk industrial projects with high reward possibilities. This investment may be at any stage of implementation of the project between start-up and commencement of commercial production. Thus, Venture Capital is defined as the organised financing of relatively new enterprises to achieve substantial capital gains. A high level of risk is implied by the term 'venture capital' and is implicit in this type of investment. This topic is discussed at length in *unit 18.*

e) ***Factoring***

Factoring service caters to the requirements of the Indian Industries in the changed business environment. Its origin can be traced back to the fifteenth century. England and France used the services of specialised agents for exporting goods to their colonies. These agents later came to be known as factoring organisations.

Factoring is an arrangement between the financial institution or banks (factor) and the business concern (the supplier) which provides goods or services to its customers on credit, wherein the factor buys out clients (suppliers) book debts.

There is always a difficulty of foreign languages, customs and laws, fear of distance, occean barriers etc. which inhibit entrepreneurs from venturing into export business, consequently affecting the country's export. Factoring is a service that relieves the exporters from the fear of credit losses enabling them to offer open account terms to overseas customers. The factor takes over the administration of clients sales ledger, follow-up with debtors and evaluation of credit risks. The fee charged for these services by the factor are usually a percentage of the value of the receivables factored.

In 1990, RBI issued guidelines for factoring services providing it a statutory framework. Banks are permitted to invest in factoring companies to a certain limit but they cannot act as promoters of such companies. Investment of a bank in the shares of factoring companies including its factoring subsidiary cannot exceed in the aggregate 10% of the paid-up capital and reserve of the bank.

f) ***Forfaiting***

Forfaiting is a financial tool for exporters, enabling them to convert their 'credit sales' to 'cash sales' by discounting their receivables with an agency called forfaitor. Forfaiting denotes the purchase of trade bills or promissory notes by a bank or financial institution without recourse to seller. For exporters it is a 'Risk Management' tool as well because by selling the export receivables to the forfaiter the exporter is relieved of the inherent political and commercial risks involved in international trade. Thus, all risks and collection problems are fully the purchaser's (forfaiter's) responsibility who pays cash to seller after discounting the notes or bills. It is backed by bank guarantee. In India, the Export Import Bank of India (EXIM Bank) facilitates this service with an overseas forfaiter agency for which they charge a commission.

g) ***Bill Discounting***

Bill Discounting, just as factoring and forfaiting, is a short-term trade finance, also known as acceptance credit where one party accepts the liability of trade towards third party. Bill discounting is used as a medium of financing the current trade and is not used for financing capital purposes. Trade bills are negotiable money market instruments and these are bought by the intermediaries at a discount before their maturity. Discount houses act as intermediaries between the central bank and the banking system, providing liquidity and ensuring efficient operations of money market. Discount houses play an important role throughout the universe in the whole system of banking.

**Insurance Services**

Insurance, as we all know, is the most preferable method of handling risks and hence is also called as 'risk cover'. Risk is nothing but an uncertainity of occurrence of a loss viz. loss of lives, accidents causing permanent disability, loss of houses due to floods etc.

Insurance is a contract between two parties – the insurer (the insurance company) and the insured (the person or entity seeking the cover) – wherein the insurer agrees to pay the insured for financial losses out of any unforeseen events in return for a regular payment of "premium". In insurance the actual loss is substituted by average loss by spreading the losses of unfortunate few over the entire group. This is a financial service wherein the insured is re-established to his or her approximate financial position prior to the occurrence of loss. Thus, insurance provides an unique sense of security that no other form of investment provides.

Insurance is an attractive investment option as well. These products yield more compared to regular investment options, and this is besides the added incentives offered by insurers. It serves as an excellent tax saving mechanism too. An individual is entitled to a rebate of 20% on the annual premium payable on his/her life and life of his/her children or adult children as per section 88 of the Income Tax Act 1961. In order to nationalise the life assurance business in India, the government had set up the Life Insurance Corporation of India in 1956. Since then it remained the monopoly of the public sector, until 2001 when private players were allowed to operate in this sector. However, before opening up this sector for the private players, an autonomous insurance regulator was set up in 2000. The 'Insurance Regulatory and Development Authority' has extensive powers to oversee the insurance business and regulate it in a manner so as to safeguard the interest of the insured. Block V of this course is completely devoted to this sector wherein life insurance, non-life insurance and the broking services are given in detail.

**Activity 2**

Try to identify few other services besides the services given here.

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## 3.7 IMPACT OF TECHNOLOGY

The financial services industry both nationally and internationally is one of the most dynamic and rapidly growing sector of the economy. It is critically significant to health of the global economy as well as that of individual businesses and consumers. The overall percentage of employment in the financial services has increased. These developments are cited as a part of the 'information revolution'. Some of the effects of the information technology on the financial services sector are given below.

**From the Service Providers Point of View**

**Cost Saving**

Information technology has contributed to the containment of the cost associated with the management of information and the execution of transactions. A single transaction costs around Rs.50 if conducted through a branch, but if done through ATM this cost comes to about Rs.15. The same transaction if conducted electronically through the internet, costs only Rs.4 Thus we can see that the cost incurred by the financial services firms can be reduced to a great extent by the efficient use of technology, thereby enhancing its profitability. These cost savings can be passed on to the customers to gain a competitive advantage.

One of the major costs of the financial services firms is the labour-cost. The computerisation of bank-branches has increased the efficiency of the functioning of the banks. The networking technology has helped the banks to introduce the single window system. It means that a single person is able to handle the work which was earlier being done by a number of persons. In other words technology has reduced the labour requirements of financial services firms, drastically reducing the cost incurred by these firms on labour.

**Product Development :** In the financial services sector technological developments have been of great aid in enhancing the existing services, creating new services and also bringing about product differentiation. The traditional service of cash payment has been enhanced by providing an alternative i.e. the debit cards enabling the current account bank customer to make his payments for goods and services without using cheque thereby removing the limitation on transaction size. In UK the development of on-line and touch-screen share-dealing services have simplified the procedures for buying and selling shares.

If observed closely we find that most of the services provided by the financial services sector are not new services but rather they are the new ways of offering traditional services. For example, Internet banking can just be thought of as an alternative way of providing traditional account-based services to retail bank customers. Similarly, the Automated Teller Machines (ATMs) which most of you must be familiar with is simply an alternative way of obtaining cash or making payment. However, the use of computer, telecommunication and information technology and the drifting from conventional bank branch network is what makes these products new.

ATMs are now being used by banks for dispensing railway tickets, movie tickets etc. More value added services could be provided through ATMs thus reducing the fixed & operating costs. Information technology has thus contributed to product differentiation to a great extent, in the financial services sector.

**Marketing Tool :** Marketing of financial services is to be people-intensive and therefore subject to variability of performance or quality of service. The data base technology enables the financial institution, especially banks to access the data collected in connection with one of its services to identify the potential customers for its other services.

Most of the commercial banks, private banks, foreign banks, financial institutions etc who are members of the Indian Financial Network (INFINET) a wide area satellite based network using VSAT technology, have a wider geographical coverage, enabling these banks in tapping new markets and also for providing value added services to the existing customers. Web gives the service providers an ability to serve tens of thousands of customers each day.

**Delivery channel :** Computers were devised with a focus mainly on advantage of time and place, to the customers. With continuinig advantages of wirelers technology flexibility in delivery channel device, is being offered by banks. The successful adoption of the wireless technology has helped banks to provide anytime, anywhere & any device banking. For Ex the international network, SWIFT is being utilized for the speedy transfer of funds across international destinations.

**Decision-making Aid :** Technology is an aid in the hands of decision makers and not a replacement for managers. Artifical intelligence systems such as the Expert systems are being used for making decisions of a repetitive nature. Since this system uses a common set of decision rules, the decision-making is more consistent across the organisation, unlike human decision makers. The experience and expertise of the managers cannot be replaced by the artifical intelligence systems but definitely it can be used as a supplement to enhance the quality of their decisions.

***Globalisation***: The information technology revolution has brought about a fundamental transformation, and, no other sector has been affected by advances in technology as much as banking and finance. It has become the most important factor for dealing with the intensifying competition and the rapid proliferation of financial innovations. The surge in globalisation of finance has also gained momentum with the technological advancements which have effectively overcome the national borders. Widespread use of internet banking has widened frontiers of global banking, and it is now possible to market financial products and services on a global basis.

### From Customers Point of View

**Accessibility :** The computer as well as developments in the information & communication technology has provided an easy access to information. The web helps the customers to access much better & complete information about various products and services being provided by different financial institutions.

The customers find it easy to compare the services and rates of similar kind of services offered by different institutions and then take a decision accordingly. For Ex. the information about the different cards and the services as well as charges that go along with it, offered by various banks can now be easily accessed.

**Convenience :** The customers are no longer required to go to the banks for withdrawal of cash or to procure any information related to his/her account. The Automated Teller Machines (ATMs) can be used by the customer to withdraw cash anytime, anywhere across the country. It is also possible for them to get funds at home by using internet. It has now become convenient for customers to carry on trading online through their depository participants. Call Centres opened by financial institutions have enhanced the convenience of customers, wherein they can get assistance, as well as information, quickly and accurately.

**Speedier Settlement of Transactions :** The communication and information technology has no doubt increased the speed with which the transactions can now be made. Its now possible to settle bill payments electronically. The depositories do facilitate quick settlement of securities electronically. An internet enabled inward remittance facility for NRIs is also available. NRIs can send money anytime upto a specific limit to the recipients account, where its deposited in rupees at the prevailing rate of exchange through the RTGS (Real Time Gross Settlement). This service not only saves time but is also cheaper.

## 3.8 CHALLENGES BEFORE THE FINANCIAL SERVICES SECTOR

The financial sector now operates in a more competitive environment than before and intermediates relatively large volume of international financial flows.

Technology has thrown new challenges in the financial services sector and new issues have started cropping up which are going to pose certain problems in the near future.

- In an increasingly competitive environment between banks/insurance companies and the banks, insurance companies and other players of the financial system, it is necessary for these institutions to equip themselves with the right organisational structure. These firms need to properly revamp their organisational structure so that they are able to bear the stress and strains of growth, as well as face the challenge arising from the rapidly changing scenario. The structure should be a judicious blending of the needs for greater delegation of power, decentralisation of control and constant monitoring of performance. Designing of an appropriate organisational structure is a big challenge.

- The employees of the financial services sector (particularly those employed in the public sector banks and insurance companies) need to be trained in operating computers. Its also necessary that they should be made to appreciate the efficient use of computer in accounting transactions & also for delivering better services to their customers. Its not only computers, training and development of the staff on the changing systems (internet, electronic commerce) and procedures as well as developing the apporpriate mindsets have become absolute imperatives for the financial sector. With the liberalisation of the economy and emergence of new private participants, the acquisition and development of new and improved skills has become a pre requisite for their survival & growth. Thus, the need to train and retrain staff on a continious basis given the fast paced changes in the IT sector, is a major challenge confronting the financial services sector.

- As most of you must be aware that India is one of the signatories of Financial Services Agreement (FSA) of 1997 which gives the Indian financial sector including banks an opportunity to expand their business on a quid pro quo basis. Globalisation of finance has already gained momentum with the technological advancements breaking national borders in the financial services sector. In future globalisation would spread further on account of the likely opening up of the financial services sector under WTO. As expected, a greater number of international players would be entering the Indian financial system, the challenge before the financial institutions is to go global by searching new markets, customers and profits.

- Financial institutions will have to face competition not only at the international level but also at the domestic level and will have to compete with foreign participants operating in India. Most of the Indian firms lack in size, even India's largest bank, SBI is not even a 10th in size of the 9th largest bank Sumitomo Mitsui which has assets of $950 billion against SBIs assets of $91 billion. Size is increasingly becoming important for global participants as it is crucial to improved efficiency. Effective & efficient Intra-firm/Inter-firm consolidation (restructuring) is a major challenge before most of these institutions.

- India's largest financial institution ICICI has already moved a step ahead towards universal banking with its reverse merger with ICICI bank.

- With blurried distinction between the banking and non-banking financial intermediaries, the firm providing financial services need to come up with new products with better services in order to retain its old customers and attract new ones. However with the help of communication and networking technologies the utilization of the existing facilities could be improved to provide enhanced customer convenience and satisfaction. The major challange before the financial institutions in India thus relates to the need to introduce innovative, customer friendly products and services for which newer technologies have to be brought in multiple areas to reduce the overall transaction costs.

- Its a challenge, especially before the banks, to adopt efficient & effective communication networks to build up integrated delivery channels both vertical and horizontal by installing an enabling and compatible multi channel platform which could support and seamlessly integrate both existing and future delivery channels.

- Providing the customers a single `sign on', an unique ATM PIN, for carrying out transactions across delivery channels is also a challenge in itself.
- Globalisation and technological developments have placed new stresses on the infrastructure of financial services organisations. It has also increased their exposure to operational risks such as system failure, electronic frauds and damaged reputation. They may have to develop a decision support system on the current MIS for the better analysis of the data and risk management on real time basis, in addition to other functions such as credit decisions, foreign exchange management, treasury operations etc.
- Security is another major concern of on-line customers and it is the biggest risk to the financial service providers in terms of brand image. The need to comply with international standards including those of certification such as BS7799 or ISO 17799 to meet its information security requirements and ITIL (IT infrastructure Library) in the areas of service management is a emerging challenge before the financial services sector.
- The implementation of IT has been confined only to the metros or big urban customers its now time that the benefits of IT should be made available to the rural population as well. Here there will be a need to provide for multi-lingual facilities, which is a migration away from the existing English-only paradigm. Adequate Infrastructural facilities are must, if these benefits have to accrue.

Thus, in the fast track Internet world the financial services providers will need to invest heavily in customer relationship management system and brand identify. They may also have to adopt frameworks of best practices for implementing IT Governance using internationally accepted standards.

## 3.9 SUMMARY

We were late-starters in the field of Financial Services and almost lagged behind by about 100 years. It took quite a long time for us to think of the financial services institutions, the nature and quality of the services to be delivered by them, the latitude which could be given to them to float instruments, and the extent of regulation which could be exercised on their working by regulators. In the first stage of the development of financial services, our concentration was on the setting up and functioning of investment institutions, insurance business, leasing and merchant banking firms. In the second stage, our concentration shifted to hire purchase, factoring, venture capital funds, and reforms in the stock and capital markets. The third round of development has addressed itself to the questions of computerisation, paperless trading, setting up of depositories, innovation of new financial instruments, and integration of the financial services with the rest of the world by permitting the foreign financial institutions to have their foothold in India.

The financial services industry provides a great value addition, and is characterised by a high rate of growth which has turned out to be many times more than that achieved by agriculture and industry in India. Both the development of infrastructure and industry would require massive funds and the financial services industry would play a critical and decisive role in the development of infrastructure. However some of the factors inhibiting the growth of the financial services industry in India are lack of suitable and adequate personnel, exorbitant cost of office space and slower adoption of technology in its various operations. In this unit we have briefly discussed the various types of Financial Services provided by the Financial Institutions. These services will be dealt with in detail in the subsequent units.

## 3.10 KEY WORDS

**Financial Services :** are services rendered by finanancial institutions, facilitating the smooth flow of financial activities in the economy of the financial system

**Fee Based Services :** Financial services firms that enable the corporate sector and other to raise capital from the market and manage or transfer their risk to other participants of the market are in fee based services.

**Fund Based Services :** Financial services firms that cater the short-term term needs of funds of corporate sector and others are in the funds-based services.

**Insurance :** It is a contract between two parties, the insurer and the insured - wherein the insurer agrees to pay the insured for the financial losses arising out of any unforeseen events in return for a regular payment of 'premium'.

## 3.11 SELF ASSESSMENT QUESTIONS

i) Explain the terms financial services, and discuss the characteristics of financial services.

ii) Discuss the significance of the financial services sector in detail.

iii) Describe the various fee based services being provided by the financial institutions

iv) Explain the fund based services that are provided by the financial institutions.

v) Discuss the impact that technology has made on the financial service sector.

vi) Discuss the challenges that the banking industry is confronted with.

## 3.11 FURTHER READINGS

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