31
FINANCIAL INSTITUTIONS

31.1 INTRODUCTION

In a broad sense, finance refers to funds needed to carry out production activities. Funds are needed for meeting current requirements or day to day expenses and for buying capital goods. A business unit - factory or workshop - needs funds for paying wages and salaries, for buying raw materials. Institutions that meet all such requirements of finance are called financial institutions.

In this lesson you will learn about the need and sources of finance with special emphasis on financial institutions. In this lesson you will also read about the ways to raise finance and the institutions that provide finance.

31.2 OBJECTIVES

After going through this lesson, you will be able to:

- explain the meaning and need of finance;
- distinguish between institutional and non-institutional sources of finance;
- explain the institutional source of agricultural finance in India;
- explain the sources of industrial finance in India;
- describe some specialized financial institutions in India.

31.3 MEANING OF FINANCING

Arrangement of money to be used for any purpose is financing. One thing that has to be kept in mind is that finance does not come free. It commands a price. And the price paid for obtaining finance is called the rate of interest. The need for financing arises when you require funds to start any production activity. You may be able to raise part of the resources but for the remaining part you have to look for other sources. This arrangement of money is called 'financing.

31.4 NEED FOR FINANCING

We have already said that all the sectors of the economy - agriculture, industry, infrastructure services - require finance. Even a very small business need cannot be fulfilled unless you have money at your disposal.

This money can either be provided through own funds or borrowed. This borrowing of money from other sources is called financing. Its need arises because to carry out a business activity a large amount of money is required which cannot be met through own funds.

(a) Need for finance and period of time

The need for finance can be classified into three categories according to the period of time and the purpose for which finance is required.

(i) Short term needs

(ii) Medium term needs

(iii) Long term needs

(i) Short term finance :

These are funds required for short period of **less than 15 months** for meeting the day to day expenses. For example, to buy raw materials or to pay wages to the labour or to meet any other day to day requirement.

(ii) Medium term finance :

These are funds required for medium period ranging **between 15 months and five years** for making improvement on land, plant, for purchasing equipment, machinery, etc. These loans are larger than short term loans and can be repaid over longer periods of times.

(iii) Long term finance :

These loans are taken for long periods of **more than 5 years** and are used for purposes of buying land, factory building, to make permanent improvements on land, to pay off old debt and to purchase costly machinery.

(b) Money market vs. capital market

Sources which meet short term requirements of money are the constituents of the **money market** and the sources which meet medium and long term requirements of money are the constituents of the **capital market**.

POINTS TO REMEMBER

- The money needed to purchase goods, equipment, premises, etc. to start any production activity is called finance.
- Need for financing can be classified as (a) Short term finance, (b) Medium term finance and (c) Long term finance according to the period of time and the purpose for which finance has been taken.
- The price paid for obtaining finance is called the rate of interest.
- Sources which meet short term requirements of money are the constituents of the money market and the sources which meet medium and long term requirements of money are the constituents of capital market.

INTEXT QUESTIONS 31.1

Fill in the following blanks :

(i) The money needed to start any production activity is called __________.

(ii) Institutions engaged in the arrangement of finance are called __________.

(iii) Price paid to obtain finance is known as the ___________.

(iv) Short term finance is funds taken for a period less than ___________.

31.5 SOURCES OF FINANCE

We require finance to carry out various production activities. For this, we have to borrow funds. Now the question is - from where do we obtain this finance. We can take loans from friends, moneylenders, mahajans, relatives or from specialised agencies like banks, co-operative societies, finance corporations, Unit Trust of India (UTI), Life Insurance Corporation (LIC), etc. All these sources of finance can be classified into two :

(a) Non-institutional sources, and
(b) Institutional sources

(a) Non-institutional Sources of Finance :
Loans from individuals, for example, loans taken from moneylenders, mahajans, friends, relatives, etc. are called non-institutional sources of finance.

(b) Institutional Sources of Finance :
Institutional sources of finance include organisations or establishments which are set up to provide finance. They have a specialised objective and that is provision of finance. Such institutions or organisations are also called financial institutions. Examples of institutional sources of finance are banks, cooperative societies, insurance companies, UTI, State Finance Corporations, Development Banks, etc.

arrangements for the supply of credit to rural areas.

It provides short term, medium term and long term credit to State Cooperative Banks, Regional Rural Banks, and other financial institutions approved by the Reserve Bank of India.

It not only provides loans for agricultural activities but also for activities related to agriculture and also promotes research in agriculture and rural development.

POINTS TO REMEMBER

- In the agricultural sector, initially non-institutional sources were the most important sources of finance.
- Due to the exploitative nature of the non-institutional sources government and the Reserve Bank of India have helped set up various agencies in the rural areas which provide institutional finance.
- Some of these agencies are Commercial Banks, Regional Rural Banks, Land Development Banks, Co-operative Credit Societies and the NABARD.
- NABARD is the apex bank in the provision of institutional finance in the rural areas.

INTEXT QUESTIONS 31.3

Fill in the following blanks :

(i) Loan from a moneylender is an example of ____________________ finance.

(ii) Commercial banks were nationalised in the year ________________.

(iii) Apart from short term loans Commercial Banks also provide ____________ loans.

(iv) RRBs were set up in ________________.

(v) The co-operative credit societies have a ________________ tier structure.

31.7 SOURCES OF INDUSTRIAL FINANCE

(a) Need

Industries need two types of finance. First, to buy fixed capital goods like land, building, machines, equipment etc. Second, to meet working capital requirements to buy raw materials, to pay wages and salaries, and to meet other day to day expenses. To meet fixed capital n.ed long term finance and to meet working capital need short term finance are required.

entrepreneur or industrialist is in a position to start a new unit from its own resources. He ... to take recourse to outside resources. Besides, an industrial unit needs more finance th... an agricultural unit.

... du rial units are located in and around cities. Friends, relatives, moneylenders etc. ... s don't have resources enough to meet the needs of finance of a production unit. ... nstitutional sources have little role to play in industrial finance.

(b) Sources of finance

The main sources of industrial finance within the country are :

1. Public issues (of shares and debentures)
2. Public deposits
3. Loans from commercial banks
4. Industrial banks

1. Public issues (shares and debentures)

By public issue is meant an open invitation to general public by an industrial unit to invest money in that unit. This invitation is designed according to law and is subject to certain rules and regulations. The invitation is given after obtaining permission from the relevant government department. The industrial unit extending the invitation has to follow certain rules.

Finance through public issues is obtained by issuing shares and debentures. Their price is fixed in advance. Any individual or institution buying shares is treated as one of the owners of share issuing company. In this way there can be thousands and lakhs of shareholders of a company. Debenture holders have no concern with ownership or management of the company. They get only interest at some pre-determined rate of interest.

The major portion of the long term finance requirements of an industrial unit is met by issuing shares and debentures. Anybody can buy these shares and debentures, whether an individual, a firm, a bank or any other institution. That is why these issues are called public issues.

How much money people like to invest in a public issue depends on the business environment and the confidence of people on capital market. If the environment is not favourable and the confidence in capital market shakes, the common man fights shy of making investment in public issues. During the recent years industrial concerns are finding it difficult to raise money through public issues due to uncertainties in the capital market.

2. Public Deposits

This is a method of taking loans from the general public. The companies invite fixed deposits from the general public. Companies pay a fixed rate of interest on these deposits. These deposits are usually for a period of one to five years. These deposits are guided by certain rules and regulations. The rules are framed by the Reserve Bank of India and the companies compulsorily adopt these rules. How much money a company can raise from this source depends on the confidence the people have in that company. Generally, the reputed companies are in a position to raise finance at reasonable rate of interest because the people have confidence in them. When the confidence is shaken people fight shy of making deposits. Industrial units in general are not able to raise money from this source. Only a few well known companies are able to raise money from this source.

3. Commercial Banks

Commercial banks give loans to industrial units. But these are generally short-term loans which meet only working capital requirement. Banks normally do not give long term loans. They also do not subscribe to share and debentures because they find it risky. There is a fear of loss of investment. Banks need money continuously. Therefore, commercial banks do not show much interest in long term financial needs of the industries.

4. Industrial Banks

We have observed that commercial banks do not show interest in long term financial needs of industries because they do not want to lock their money for a long period. This requirement is fulfilled by industrial banks. These banks were established after Independence.

Industrial banks are specialised financial institutions established by government to meet long term finance requirements of industries. Thus industrial banks are complementary to the commercial banks because commercial banks meet only the short term requirements.

Some examples of such specialised financial institutions are :

1. Industrial Development Bank of India (IDBI)
2. Industrial Finance Corporation of India (IFCI)
3. Industrial Credit and Investment Corporation of India (ICICI)
4. Industrial Reconstruction Corporation of India (IRCI)
5. Unit Trust of India (UTI)
6. National Small Industries Corporation (NSIC)
7. State Financial Corporations (SFCs)
8. State Industrial Development Corporations (SIDCs)
9. State Industrial Investment Corporations (SIICs)
10. Export-Import Bank of India (EXIM Bank)

These are only some examples. There are other institutions also. These institutions do not only finance but encourage industries by giving them technical advice, market information and evaluating projects.

(c) Industrial banks vs. Commercial banks

These banks are different from commercial banks in these respects :

(i) People cannot deposit money in industrial banks while they can do so in commercial banks.

(ii) These banks give medium term and long term loans while commercial banks give short term loans.

(iii) These banks, in addition to finance, help in the development of industries by offering technical advice and market information. Commercial banks confine to giving loans only.

31.8 SOME SPECIALISED FINANCIAL INSTITUTIONS

We have given a list of some specialised financial institutions. Now we discuss some of these specialised financial institutions in detail.

1. Industrial Finance Corporation of India (IFCI)

IFCI was the first to be set up in the existing chain of development banks in 1948 by the Government of India. It provides medium and long term credit to industry.

The Corporation performs three important functions:

(i) It grants loans and advances to industrial concerns and subscribes to the debentures floated by them.

(ii) It guarantees loans raised by the industrial concerns in the capital market.

(iii) It underwrites the issue of stock, shares, bonds and debentures of industrial concerns.

IFCI provides long and medium term finance only to companies engaged in manufacturing, mining, shipping and generation and distribution of electricity.

The limit of assistance to any single concern is now Rs.1 crore and the period of loans is not to exceed 25 years.

2. Industrial Development Bank of India (IDBI)

The IDBI came into existence in 1964 and is now the apex institution providing term finance. The main function of IDBI is to finance industrial enterprises such as manufacturing, mining, processing, shipping and other transport industries and hotel industry.

It provides direct assistance by way of project loans, underwriting of and direct subscription to industrial securities.

It also refinances term loans given by other financial institutions.

3. Industrial Credit and Investment Corporation of India (ICICI)

ICICI was set up in January, 1955 for the purpose of developing small and medium industries in the private sector.

The aim of ICICI is to stimulate the promotion of new industries, to assist the expansion and modernisation of existing industries and to furnish technical and managerial guidance. The Corporation grants:

(i) long term or medium term loans
(ii) guarantees loans from other private sources
(iii) participates in equity capital and underwrites new issues of shares and debentures.

ICICI has so far assisted industries manufacturing paper, chemicals and pharmaceuticals, electrical equipment, textiles, sugar, metal ore, lime and cement works, glass manufacture, etc. ICICI assists all sectors, that is, the private sector, the joint sector, the public sector and the cooperative sector but the major beneficiary is the private sector

4. Small Industries Development Bank of India (SIDBI)

SIDBI was set up in 1990 as a wholly owned subsidiary of IDBI.

It is the principal financial institution for financing and development of small scale industries in the country. It extends financial assistance to the small units scattered all over the country.

5. Export - Import Bank of India (EXIM Bank)

The EXIM Bank of India was set up in 1982 to provide finance for the development of exports. Its main objective is to solve the problems of exporters, provide special attention to capital goods exports and export of technical services.

It provides financial assistance to the exporters and importers and acts as the principal financial institution for coordinating the working of other institutions engaged in financing exports and imports.

6. Unit Trust of India (UTI)

The UTI was set up in 1964 at the initiative of the RBI. It is a 50 per cent subsidiary of the IDBI. The rest of the 50 per cent is subscribed by the LIC, the State Bank of India, other scheduled banks, the IFCI and the ICICI.

The main source of funds of the UTI is the sale of units to the public under various schemes. By selling these units they collect and mobilise savings from the general public and lends them to the investors. It also participates in the underwriting of the new issues of debentures and shares.

POINTS TO REMEMBER

- The main sources of industrial finance are - Shares and Debentures, Loans from Commercial Banks, Deposits from the public.
- Industrial banks are specialised institutions which in addition to giving loans help in the development of industrial units.
- Some of the important industrial banks are IDBI, IFCI, ICICI, SIDBI, EXIM Bank etc.

INTEXT QUESTIONS 31.4

State whether the following statements are true or false :

(i) UTI seeks deposits from the public as the commercial banks do.
(ii) IFCI provides medium term and long term loans.
(iii) IFCI was the first to be set up in the chain of industrial banks.
(iv) UTI was established on the initiative of the Government of India.

31.9 FUTURE PERSPECTIVE

As the economy develops financial needs and requirements of all the sectors - agriculture, industry, services, infrastructure - also grow and therefore the availability of institutional finance will also have to increase. Not only is there need to expand the existing agencies of institutional finance but also need for opening new ones. Growth of financial institutions is a necessity for the growth of the economy.

TERMINAL EXERCISE

What is the meaning of financing? Why do we need financing?
Explain the need for financing according to time period. In this context distinguish between money market and capital market.
Differentiate between institutional and non-institutional source of finance.
Name the institutional sources of agricultural credit. Explain any one of these in detail.
State the need of industrial credit in India.
Write a note on public issues as a source of industrial credit.

7. What are the main sources of industrial credit in India? Explain any one of these in detail.
8. How are the industrial banks different from the commercial banks?
9. Name five financial institutions providing financial assistance to industries. Describe any one of these in detail.

ANSWERS

Intext Questions 31.1

(i) finance (ii) financial institutions (iii) rate of interest (iv) 15 months

Intext Questions 31.2

(i) False (ii) False (iii) True (iv) True

Intext Questions 31.3

(i) Non-institutional, (ii) 1969, (iii) medium term (iv) 1975 (v) three

Intext Questions 31.4

(i) True (ii) True (iii) True (iv) False

Terminal Exercise

1. Read section 31.3 & 31.4
2. Read section 31.4 (a) & (b)
3. Read section 31.5
4. Read section 31.6
5. Read section 31.7(a)
6. Read section 31.7(b)
7. Read section 31.7(b)
8. Read section 31.7(c)
9. Read section 31.8