Lesson Objectives
To understand the Concept of Financial Services, its classification and activities.

In general, all types of activities, which are of a financial nature could be brought under the term ‘financial services’. The term ‘financial services’ in a broad sense means “mobilizing and allocating savings”. Thus it includes all activities involved in the transformation of savings into investment.

The financial services can also be called ‘financial intermediation’. Financial intermediation is a process by which funds are mobilized from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers.

Thus, financial services sector is a key area and it is very vital for industrial developments. A well developed financial services industry is absolutely necessary to mobilize the savings and to allocate them to various invest able channels and thereby to promote industrial development in a country.

Classification of Financial Services Industry
The financial intermediaries in India can be traditionally classified into two:

i. Capital Market intermediaries and
ii. Money market intermediaries.

The capital market intermediaries consist of term lending institutions and investing institutions which mainly provide long term funds. On the other hand, money market consists of commercial banks, co-operative banks and other agencies which supply only short term funds. Hence, the term ‘financial services industry’ includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers.

Scope of Financial Services
Financial services cover a wide range of activities. They can be broadly classified into two, namely:

i. Traditional Activities
   a. Fund based activities and
   b. Non-fund based activities.

ii. Dealing in secondary market activities.
iii. Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.
iv. Involving in equipment leasing, hire purchase, venture capital, seed capital.
v. Dealing in foreign exchange market activities.

Non fund based activities: Financial intermediaries provide services on the basis of non-fund activities also. This can be called ‘fee based’ activity. Today customers, whether individual or corporate, are not satisfied with mere provisions of finance. They expect more from financial services companies. Hence a wide variety of services, are being provided under this head. They include:

i. Managing the capital issue - i.e. management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issue.
ii. Making arrangements for the placement of capital and debt instruments with investment institutions.
iii. Arrangement of funds from financial institutions for the clients’ project cost or his working capital requirements.
iv. Assisting in the process of getting all Government and other clearances.

Modern Activities
Beside the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been in brief under the head ‘New financial products and services’. However, some of the modern services provided by them are given in brief hereunder.

i. Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approvals.
ii. Planning for M&A and assisting for their smooth carry out.
iii. Guiding corporate customers in capital restructuring.
iv. Acting as trustees to the debenture holders.
v. Recommending suitable changes in the management structure and management style with a view to achieving better results.
vi. Structuring the financial collaborations / joint ventures by identifying suitable joint venture partners and preparing joint venture agreements.
vii. Rehabilitating and restructuring sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.
Causes For Financial Innovation

Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with the increasingly volatile and uncertain market place. There is a dire necessity for innovation to meet the dynamically changing needs of the economy and to help the investors cope with the increasingly volatile and uncertain market place. There is a dire necessity for financial intermediaries to go for innovation due to the following reasons:

i. Low profitability: The profitability of the major FI, namely the banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So, they have been compelled to seek out new products which may fetch high returns.

ii. Keen competition: The entry of many FIs in the financial sector has led to severe competition among them. This keen competition has paved the way for the entry of varied nature of innovative financial products so as to meet the varied requirements of the investors.

iii. Economic Liberalization: Reform of the Financial sector constitutes the most important component of India's programme towards economic liberalization. The recent economic liberalization measures have opened the door to foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.

iv. Improved communication technology: The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities.

v. Customer Service: Now a days, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the existing ones. To meet this increased customer sophistication, the financial intermediaries are constantly undertaking research in order to invent a new product which may suit to the requirement of the investing public.

vi. Global impact: Many of the providers and users of capital have changed their roles all over the world. FI have come out of their traditional approach and they are ready to assume more credit risks.

vii. Investor Awareness: With a growing awareness amongst the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land etc. to financial assets like shares, debentures, mutual funds, etc. Again, within the financial assets, they go from 'risk free' bank deposits to risky investments in shares. To meet the growing awareness of the public, innovations has become the need of the hour.

Financial Engineering

The growing need for innovation has assumed immense importance in recent times. This process is being referred to as financial engineering. 'Financial engineering is the design, development and implementation of innovative financial instruments and process and the formulation of creative solutions to the problems in finance'.

New Financial Products and Services

In these days of complex finances, people expect a financial service company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance. With the opening of the economy to multinationals, the free market concept has assumed much significance. As a result, the clients both corporate and individuals are exposed to the phenomena of volatility and uncertainty and hence they expect the financial services company to innovate new products and services so as to meet their varied requirements.

As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened. Moreover, there has been a structural change in the international capital
market with the emergence of new products and innovative techniques of operation in the capital market. Many financial intermediaries including banks have already started expanding their activities in the financial services sector by offering a variety of new products. As a result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are briefly explained hereunder:

i. **Merchant Banking**: A merchant banker is a financial intermediary who helps to transfer capital from those who possess it to those who need it. Merchant banking includes a wide range of activities such as management of customer securities, portfolio management, project counseling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporate, and thus promote industrial development in the country.

ii. **Loan Syndication**: This is more or less similar to consortium financing. But this work is taken up by the merchant banker as a lead manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a government department. It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

iii. **Factoring**: Factoring refers to the process of managing the sales register of a client by a financial services company. The entire responsibility of collecting the book debts passes on to the factor.

iv. **Mutual Funds**: A mutual fund refers to a fund raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view to spreading and minimizing the risk. The fund provides investment avenues for small investors who cannot participate in the equities of big companies. It ensures low risk, steady returns, high liquidity and better capitalization in the long run.

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vi. **Forfaiting**: Forfaiting is a technique by which a forfaitor (financing agency) discounts an export bill and pays ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills.

vii. **Venture Capital**: A venture capital is another method of financing in form of equity participation.

viii. **Custodial Services**: Under this a financial intermediary mainly provides services to clients, for a prescribed fee, like safe keeping of financial securities and collection of interest and dividends.

ix. **Corporate advisory services**: Financial intermediaries particularly banks have setup specialized branches for this. As new avenues of finance like Euro loans, GDRs etc. are available to corporate customers, this service is of immense help to the customers.

x. **Securitisation**: Securitisation is a technique whereby a financial company converts its illiquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable.

xi. **Derivative Security**: A derivative security is a security whose value depends upon the values of other basic variable backing the security. In most cases, these variables are nothing but the prices of traded securities.

xii. **New products in Forex Markets**: New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them are:

a. **Forward contract**: A forward transaction is one where the delivery of foreign currency takes place at a specified future date for a specified price. It may have a fixed or flexible maturity date.

b. **Options**: As the very name implies, it is a contract where in the buyer of options has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his options.

c. **Futures**: It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange.

d. **Swaps**: A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates.

xiii. **Lines of Credit**: It is an innovative funding mechanism for the import of goods and services on deferred payment terms. LOC is an arrangement of a financing institution of one country with another to support the export of goods and services to as to enable the importer to import on deferred payment terms.

**Challenges Facing the Financial Services Sector**

Though financial services sector is growing very fast, it has its own set of problems and challenges. The financial sector has to face many challenges in its attempt to fulfill the ever-growing financial demands of the economy. Some of the important challenges are briefly explained hereunder:

i. **Lack of qualified personnel**: The financial services sector is fully geared to the task of financial creativity. However, this sector has to face many challenges. The dearth of qualified and trained personnel is an important impediment in its growth.

ii. **Lack of investor awareness**: The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments.

iii. **Lack of transparency**: The whole financial system is undergoing a phenomenal change in accordance with the
requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner.

iv. **Lack of specialization** : In the Indian scene, each financial intermediary seems to deal in a different financial service lines without specializing in one or two areas. In other countries, financial intermediaries specialize in one or two areas only and provide expert services.

v. **Lack of recent data** : Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon ‘financial creativity’.

vi. **Lack of efficient risk management system** : With the opening of the economy to multinationals and exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilization of multi currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk.

The above challenges are likely to increase in number with the growing requirements of the customers. The financial services sector should rise up to the occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

**Present Scenario**

The Indian economy is in the process of rapid transformation. Reforms are taking place in every field / part of economy. Hence financial services sector is also witnessing changes. The present scenario can be explained in following terms :

i. **Conservatism to dynamism** : The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment and thus to promote the accelerated growth of the economy as a whole. At present numerous new FIs have started functioning with a view to extending multifarious services to the investing public in the area of financial services.

ii. **Emergence of Primary Equity Market** : The capital markets, which were very sluggish, have become a very popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 22 in 1994. After the lowering of bank interest rates, capital markets have become a very popular mode of channelising the savings of medium class people.

iii. **Concept of Credit Rating** : The investment decisions of the investors have been based on factors like name recognition of the company, operations of the Group, market sentiments, reputation of the promoters etc. Now grading from an independent agency would help the investors in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company’s point of view, Equity grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Now it is mandatory for the non-banking financial companies to get credit rating for their debt instruments.

iv. **Process of globalization** : The process of globalization has paved the way for the entry of innovative and sophisticated products into our country. Since the Government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentials for the introduction of innovative, international financial products in India are very great. Moreover, our country is likely to enter the full convertibility era soon. Hence, there is every possibility of introduction of more and more innovative and sophisticated financial services in our country.

v. **Process of liberalization** : Our government has initiated many steps to reform the financial services industry. The government has already switched over to free pricing of issues by the CCI. The interest rates have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized. SEBI has liberalized many stringent conditions so as to boost the capital and money markets.