

# Indian Financial System

## Solved Question Paper – February 2025

### SECTION-A

1. Answer any Five sub-questions. Each sub-question carries Two marks.

a) Define Financial System.

Answer: The **financial system** is a network of public and private institutions, markets, and instruments that enables the flow of money within an economy. It connects savers and investors, allowing capital to move efficiently and supporting overall economic stability and growth.

b) Expand: IRDA, RBI.

Answer:

- **IRDA** stands for the **Insurance Regulatory and Development Authority** (now IRDAI, the Insurance Regulatory and Development Authority of India), which regulates the insurance industry.
- **RBI** stands for the **Reserve Bank of India**, which is the country's central bank that regulates the banking and monetary policy.

c) What do you mean by Primary market?

Answer: The **primary market**, also known as the new issue market, is the segment of the capital market where new securities (like shares, bonds, and debentures) are issued for the first time by companies or governments to raise capital directly from investors. The funds raised go directly to the issuer.

d) What are Equity Shares?

Answer: **Equity shares** represent ownership in a company. Holders of these shares are part-owners, are entitled to voting rights on company matters, can receive a share of the profits through dividends, and may benefit from capital appreciation of their shares over time.

e) Define debentures.

Answer: A **debenture** is a type of long-term debt instrument issued by companies or governments to raise funds without pledging any specific collateral or security. The value of the debenture depends on the issuer's creditworthiness, and investors receive fixed interest payments over a set term, with the principal repaid at maturity.

f) Name any two functions of secondary market.

Answer: Two key functions of the **secondary market** are:

1. **Providing liquidity:** It allows investors to easily buy and sell existing securities, ensuring they can convert their investments into cash when needed.
2. **Facilitating price discovery:** Continuous trading in the market helps determine the fair and transparent prices of securities based on supply and demand.

g) Name any four Commercial Banks.

Answer: Four major commercial banks in India are the **State Bank of India (SBI)**, **HDFC Bank**, **ICICI Bank**, and **Axis Bank**.

## h) What do you mean by SLR?

Answer: **SLR** stands for **Statutory Liquidity Ratio**. It is a minimum percentage of deposits that commercial banks in India are required to maintain as liquid assets like cash, gold, or other approved securities with themselves, which helps control credit flow and ensures banks can meet withdrawal demands.

### SECTION-B

Answer any Four questions. Each question carries Five marks.

#### 2. Distinguish between money market and capital market.

Answer:

The **money market** and **capital market** are distinct components of the financial system, primarily differentiated by the maturity of the financial instruments they trade.

Feature	Money Market	Capital Market
<b>Purpose</b>	Deals with short-term funds (maturity < 1 year).	Deals with long-term investments (maturity > 1 year).
<b>Instruments</b>	Trades in highly liquid instruments like Treasury bills, commercial paper, and certificates of deposit.	Trades in securities like shares, stocks, bonds, and debentures.
<b>Participants</b>	Major participants include the RBI, commercial banks, and financial institutions.	Participants include individual investors, financial institutions, brokers, and corporations.
<b>Risk &amp; Return</b>	Generally involves lower risk and lower potential returns.	Involves higher risk but also offers higher potential returns.
<b>Geographical presence</b>	Does not have a fixed physical or geographical location.	Has an organized presence in the form of stock exchanges like the NSE and BSE.

#### 3. Name different types of money market Instruments.

Answer: Common types of **money market instruments** include:

- **Treasury Bills (T-bills)**
- **Commercial Paper (CP)**
- **Certificates of Deposit (CDs)**
- **Call Money** (or Ready Money)

#### 4. Write a short note on SEBI.

Answer:

The **Securities and Exchange Board of India (SEBI)** is the regulatory body for the securities market in India. It was established in 1988 and given statutory powers in 1992. SEBI's main functions are to

protect the interests of investors, promote the development of the securities market, and regulate the business within the market to ensure fair practices and transparency. It regulates both primary and secondary markets.

### 5. What are the different types of forfeiting?

Answer: Forfeiting is a financing method used for receivables associated with international trade. There are various types, often classified based on the nature of the transaction or risk coverage:

- **With Recourse vs. Without Recourse:** In non-recourse forfeiting, the forfaiter (buyer of the receivable) absorbs the risk of default by the importer, which is the more common form, providing full protection to the exporter. With recourse means the exporter remains liable for non-payment.
- **Based on disclosure:** Disclosed forfeiting means the importer is aware the receivable has been sold to a forfaiter, while undisclosed means they are not.
- **Direct vs. Two-factor system:** Domestic forfeiting involves parties in one country, while export/international forfeiting involves two factors in different countries (export and import factors).

### 6. Name the different types of debentures.

Answer: Debentures can be classified in several ways:

- **On the basis of security:** **Secured** (backed by assets) and **unsecured** (naked debentures, backed only by creditworthiness).
- **On the basis of transferability:** **Registered** (issuer maintains a record of holders) and **unregistered** or **bearer** (easily transferable).
- **On the basis of permanence:** **Redeemable** (fixed maturity date for repayment) and **irredeemable** or **perpetual** (no fixed maturity date).
- **On the basis of convertibility:** **Convertible** (can be converted into equity shares), **non-convertible** (cannot be converted), and **partially convertible**.

### 7. What are the objectives of RBI?

Answer: The **Reserve Bank of India (RBI)** has several key objectives:

- To manage the **monetary policy** of the country, ensuring financial stability and controlling inflation/deflation.
- To act as the **regulator and supervisor** of the entire banking system in India.
- To issue currency and manage foreign exchange reserves.
- To ensure an adequate flow of credit to various productive sectors of the economy.

## SECTION-C

Answer any Three questions. Each question carries fifteen marks.

### 8. Prepare the structure of Indian Financial System and explain its components in one or two sentences.

Answer:

The **Indian financial system** is a complex, integrated framework designed to facilitate the flow of funds between savers and borrowers, thereby supporting economic growth. Its structure primarily comprises four interconnected components:

- **Financial Institutions:** These are organizations like banks, insurance companies, and non-banking financial companies (NBFCs) that mobilize savings and provide loans and other financial services.
- **Financial Markets:** These are platforms (e.g., stock exchanges, money markets) where financial instruments are created and traded, facilitating price discovery and liquidity.
- **Financial Instruments (Assets):** These are the tools used for investing and borrowing, such as stocks, bonds, debentures, and mutual funds, representing claims on assets or income streams.
- **Financial Services:** These are activities and services provided by various intermediaries, including advisory, wealth management, credit rating, factoring, and insurance, which support financial transactions and risk management.

## 9. Discuss the functions of financial Intermediaries.

Answer:

**Financial intermediaries** (such as banks, mutual funds, and insurance companies) play a crucial role by acting as a go-between for lenders (savers) and borrowers (investors). Their core functions include:

- **Mobilisation of Savings:** They attract deposits from a large number of savers by offering various schemes and channel these funds into productive investments.
- **Risk Management and Diversification:** Intermediaries help manage risk by pooling funds and investing in a diversified portfolio of assets, reducing the impact of any single investment's performance.
- **Liquidity Creation:** They provide liquidity by offering access to funds when needed (e.g., allowing bank withdrawals or the sale of mutual fund units), which ensures continuous functioning of the markets.
- **Price Discovery:** Through their activities, intermediaries help determine the fair market prices for financial assets based on supply and demand dynamics.
- **Reducing Transaction Costs:** They lower the cost and time individuals would need to find potential borrowers or lenders on their own by bringing many participants together in one place.

## 10. Explain the various types of fund-based services.

Answer:

**Fund-based financial services** involve institutions directly providing or managing funds for clients. Types include:

- **Equipment Leasing/Lease Financing:** A company obtains the right to use a capital asset for a fee (lease rental) without gaining ownership.
- **Hire Purchase and Consumer Credit:** The buyer gains possession of goods immediately but ownership is transferred only after the final instalment payment, with each payment including interest.
- **Bill Discounting:** The holder of a time bill can receive immediate funds from a bank or finance company by selling the bill at a discount before its maturity date.
- **Venture Capital:** Providing long-term, high-risk capital (usually equity finance) to new or expanding business ventures with high growth potential.
- **Housing Finance:** Financial assistance provided for the construction or purchase of houses.
- **Factoring and Forfeiting:** Factoring involves selling accounts receivable to a third party (factor) for immediate cash to manage short-term cash flow, while forfeiting is similar but for international trade receivables.

- **Mutual Funds:** Pooling money from multiple investors to invest in a diversified portfolio of securities managed by professionals.

### 11. Explain the role of Commercial Banks in the Economic Development of India.

Answer:

**Commercial banks** are vital to India's economic development by fuelling growth across various sectors. Their key roles include:

- **Mobilization of Savings and Capital Formation:** They attract savings from individuals and businesses through various deposit schemes and channel these funds into productive investments, which is crucial for capital formation.
- **Credit Creation and Allocation:** Banks provide loans and credit facilities to industries, agriculture, and small businesses, which has a multiplier effect on the economy by enabling investment, consumption, and expansion.
- **Facilitating Trade and Commerce:** They smooth trade transactions by offering services like fund transfers, letters of credit (especially in international trade), and various digital payment mechanisms (like UPI, NEFT).
- **Promoting Entrepreneurship and Employment:** By providing capital to entrepreneurs and small enterprises (MSMEs), banks encourage self-sufficiency, reduce unemployment, and support new ventures.
- **Implementing Government Policies:** They help implement government developmental goals, such as financial inclusion and rural outreach, by spreading banking activities across different regions.

### 12. Explain the functions of RBI in brief.

Answer:

The **Reserve Bank of India (RBI)**, as India's central bank, performs several critical functions:

- **Monetary Authority:** Controls the money supply, manages interest rates (repo rate, reverse repo rate), and uses credit control measures (CRR, SLR) to achieve macroeconomic objectives like controlling inflation and ensuring financial stability.
- **Regulator and Supervisor:** Regulates and supervises all banks and non-banking financial institutions to maintain public confidence and protect depositors' interests.
- **Issuer of Currency:** Has the sole right to issue currency notes and coins (except one-rupee coins) and manages their circulation.
- **Banker to the Government:** Manages the government's banking transactions, including receipts and payments, and acts as its debt manager.
- **Banker to Banks:** Maintains banking accounts of all commercial banks, acts as a lender of last resort, and facilitates inter-bank fund transfers through clearing houses.
- **Manager of Foreign Exchange:** Manages the country's foreign exchange reserves and exchange control to facilitate external trade and maintain the rupee's value.

## SECTION-D

Answer the following question. Question carries Five marks.

### 13. Prepare the list of Financial Regulator in India and state any two objectives of each regulator.

Answer:

The major financial regulators in India and two of their key objectives are:

- **Reserve Bank of India (RBI)**
  - To maintain monetary stability and control inflation.
  - To regulate and supervise commercial banks and other financial institutions.
- **Securities and Exchange Board of India (SEBI)**
  - To protect the interests of investors in securities.
  - To regulate the securities market and prevent malpractices.
- **Insurance Regulatory and Development Authority of India (IRDAI)**
  - To protect the interests of insurance policyholders.
  - To regulate, promote, and ensure the orderly growth of the insurance industry.
- **Pension Fund Regulatory and Development Authority (PFRDA)**
  - To promote old-age income security.
  - To regulate and ensure the orderly growth of pension funds.

# Indian Financial System

## Solved Question Paper – February 2025-26

### SECTION-A

Answer any Five of the following sub-questions. Each sub-question carries 2 marks.

a) State any two objectives of financial system.

Answer: Two primary objectives of a **financial system** are:

1. **Mobilization of Savings:** To encourage individuals and businesses to save and pool those savings for productive use.
2. **Allocation of Capital:** To efficiently channel funds from savers to borrowers (investors) to support economic growth and development.

b) What is secondary market?

Answer: The **secondary market**, also known as the stock market, is where previously issued securities (like stocks and bonds) are bought and sold among investors. Unlike the primary market, the issuing company does not receive new capital from these transactions; instead, it provides **liquidity** and a platform for **price discovery**. (p. 4)

c) What is a mutual fund?

Answer: A **mutual fund** is a financial vehicle that pools money from many investors to purchase a diversified portfolio of securities like stocks, bonds, or short-term debt. It is managed by professional **fund managers** who allocate the assets to produce capital gains or income for the investors. (p. 4)

d) What are preference shares?

Answer: **Preference shares** are a type of stock that grant holders a higher claim on a company's assets and earnings than common (equity) shares. They typically pay a **fixed dividend** and have priority over equity shareholders in the event of company liquidation, though they usually do not carry voting rights. (pp. 4, 6)

e) What is factoring?

Answer: **Factoring** is a financial transaction and a type of debtor finance in which a business sells its accounts receivable (invoices) to a third party (called a **factor**) at a discount. This allows the business to receive immediate cash to meet its short-term liquidity needs. (pp. 4-5)

f) What is letter of credit?

Answer: A **letter of credit** is a document issued by a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. If the buyer is unable to make the payment, the bank is required to cover the full or remaining amount of the purchase, providing **security** for international trade. (p. 4)

g) What is scheduled Bank?

Answer: A **scheduled bank** in India is a bank that is included in the **Second Schedule of the Reserve Bank of India Act, 1934**. To be scheduled, a bank must meet specific criteria regarding its paid-up capital and reserves, and it becomes eligible for loans from the RBI at the bank rate.

h) Mention any two objectives of R.B.I.

Answer: Two objectives of the **Reserve Bank of India (RBI)** are:

1. **Price Stability:** Maintaining low and stable inflation to support sustainable economic growth.

2. **Financial Stability:** Ensuring the health and stability of the banking and financial systems through regulation and supervision.

## SECTION-B

Answer any Four of the following questions. Each question carries 5 marks.

### 2. Write short notes on I.R.D.A.I.

Answer: The **Insurance Regulatory and Development Authority of India (IRDAI)** is the statutory body responsible for regulating and promoting the insurance and re-insurance industries in India. Its key roles include protecting the interests of **policyholders**, ensuring the orderly growth of the insurance sector, and maintaining the financial integrity of insurance providers. It sets standards for conduct, solvency, and licensing for all insurance companies operating in the country. (p. 5)

### 3. Briefly explain the functions of Financial markets.

Answer: **Financial markets** serve several critical functions in an economy:

- **Mobilization of Savings:** They provide a platform for households to invest their savings into productive corporate ventures.
- **Price Discovery:** They help determine the prices of financial assets through the interaction of buyers (demand) and sellers (supply).
- **Providing Liquidity:** They allow investors to easily sell their assets and convert them into cash.
- **Reducing Transaction Costs:** They provide a centralized location and standardized procedures, reducing the time and effort required to trade securities.

### 4. What is money market? Briefly explain the importance of money market.

Answer: The **money market** is a segment of the financial market where short-term financial assets (with a maturity of up to one year) are traded.

**Importance:**

- **Liquidity Management:** It allows banks and corporations to manage their daily cash surpluses and deficits.
- **Implementation of Monetary Policy:** It is the primary channel through which the RBI influences interest rates and liquidity in the economy.
- **Short-term Funding:** It provides a low-cost source of working capital for businesses and the government.

### 5. What are the features of fee based services.

Answer: **Fee-based services** (also known as non-fund-based services) are financial services where the institution earns income through commissions or fees rather than interest from lending funds.

**Features:**

- **No Direct Outlay of Funds:** The institution provides expertise or guarantees rather than lending cash directly.
- **Lower Risk:** Since no capital is directly deployed, the risk of total loss is generally lower compared to fund-based services.
- **Expertise-Driven:** These services often require specialized knowledge (e.g., merchant banking, credit rating, stockbroking).

- **Diverse Range:** Includes services like portfolio management, mergers and acquisitions advisory, and issuing letters of credit.

## 6. Explain different types of Banks in India.

Answer: The Indian banking structure is diverse, consisting of:

- **Commercial Banks:** Including Public Sector Banks (e.g., SBI), Private Sector Banks (e.g., HDFC), and Foreign Banks. They focus on deposits and loans for the general public and businesses.
- **Co-operative Banks:** Organized on a co-operative basis to provide credit to small borrowers, often in rural or semi-urban areas.
- **Regional Rural Banks (RRBs):** Specialized banks aimed at providing credit to the agricultural and rural sectors.
- **Specialized Banks:** Such as EXIM Bank, SIDBI, and NABARD, which focus on specific sectors like foreign trade or small industries.

## 7. Briefly explain any three credit control measures of RBI.

Answer: The RBI uses several tools to control the supply of money and credit:

1. **Cash Reserve Ratio (CRR):** The percentage of a bank's total deposits that it must keep in cash with the RBI. Increasing CRR reduces the funds available for lending.
2. **Statutory Liquidity Ratio (SLR):** The percentage of deposits that banks must maintain in liquid assets like gold or government securities.
3. **Repo Rate:** The rate at which the RBI lends money to commercial banks. A higher repo rate makes borrowing more expensive, thereby reducing credit in the economy.

## SECTION-C

Answer any Three of the following questions. Each question carries 15 marks.

### 8. Role of Financial System in Economic Development

A well-functioning financial system acts as the "circulatory system" of an economy. Its role is multi-dimensional:

- **Capital Formation:** It encourages individuals to save by offering various investment avenues (bank deposits, stocks, etc.). These pooled savings are then converted into productive capital for industries.
- **Mobilization of Resources:** It bridges the gap between surplus units (savers) and deficit units (investors). Without this, idle cash would not contribute to national growth.
- **Industrial and Agricultural Growth:** By providing short-term and long-term credit, the system enables farmers to buy equipment and industries to build factories, directly increasing National Income.
- **Infrastructure Development:** Large-scale projects like dams, highways, and power plants require massive funding, which is facilitated through specialized financial institutions and the bond market.
- **Risk Management:** Through insurance and derivative markets, the system allows businesses to hedge against uncertainties, encouraging more ambitious entrepreneurial ventures.

- **Balanced Regional Development:** Government-mandated schemes (like Rural Banking) ensure that credit reaches backward areas, reducing the economic gap between urban and rural sectors

## 10. Types of Preference Shares

Preference shares are "hybrid" securities that combine features of both debt and equity. They are classified based on the rights they offer:

- **Cumulative Preference Shares:** If a company fails to pay a dividend in a particular year due to losses, the dividend "accumulates" and must be paid in full before any dividend is paid to equity shareholders in future profitable years.
- **Non-Cumulative Preference Shares:** Holders only receive a dividend if the company makes a profit in that specific year. Unpaid dividends do not accumulate.
- **Participating Preference Shares:** These holders receive a fixed dividend and also have a right to share in "surplus profits" after a certain level of dividend has been paid to equity shareholders.
- **Non-Participating Preference Shares:** These holders only receive their fixed rate of dividend and nothing more, regardless of how high the company's profits are.
- **Convertible Preference Shares:** These offer the option to convert the preference shares into ordinary equity shares after a specified period, allowing the holder to become a full owner.
- **Redeemable Preference Shares:** These are issued for a fixed tenure, after which the company repays the capital to the shareholders.

## 11. Various Functions of Commercial Banks

Commercial banks act as the primary financial intermediaries. Their functions are categorized as follows:

### Primary Functions

- **Accepting Deposits:** They offer different accounts (Savings, Current, Fixed, and Recurring) to suit the needs of different savers.
- **Advancing Loans:** They provide credit through Overdrafts, Cash Credit, and Direct Loans to individuals and businesses.
- **Credit Creation:** This is a unique function where banks, through the process of lending, actually increase the total money supply in the economy.

### Secondary (Agency) Functions

- **Fund Transfers:** Moving money via NEFT, RTGS, and UPI.
- **Periodic Payments:** Handling standing instructions for rent, insurance premiums, or utility bills on behalf of the customer.
- **Collection of Dividends/Interest:** Acting as an agent to collect income from the customer's investments.

### General Utility Functions

- **Locker Facilities:** Providing safe custody for valuables.
- **Underwriting:** Assisting companies in raising capital by guaranteeing the sale of their shares.
- **Foreign Exchange:** Facilitating currency exchange for international travel or trade

## 12. Detailed Role of the R.B.I.

As the apex monetary institution, the Reserve Bank of India (RBI) performs functions that maintain the country's economic integrity:

- **Monetary Policy Management:** Using tools like the Repo Rate and Reverse Repo Rate, the RBI manages the "cost of money" to control inflation while ensuring there is enough credit for growth.
- **Supervision of the Banking Sector:** The RBI sets the "rules of the game" for all banks, ensuring they remain solvent and follow fair practices to protect the common man's deposits.
- **Managing Foreign Exchange (Forex):** The RBI maintains the Forex Reserves to ensure that India can pay for imports and to prevent the Rupee from fluctuating too wildly against the Dollar.
- **Financial Inclusion:** The RBI drives initiatives like the "Jan Dhan Yojana" to ensure that even the poorest citizens have access to a bank account.
- **Currency Management:** It is responsible for the design, production, and distribution of banknotes, ensuring that "fake currency" is kept out of the system

### SECTION-D

**Answer the following question. The question carries 5 marks.**

## 13. Draw the structure of Indian Financial Market.

Answer: The **Indian Financial Market** is broadly divided into two main segments:

1. **Money Market:** Deals with short-term funds (e.g., Call Money, Treasury Bills, Commercial Paper). It is primarily regulated by the **RBI**.
2. **Capital Market:** Deals with long-term funds. It is further divided into:
  1. **Industrial Securities Market:** Primary (New Issues) and Secondary (Stock Exchange).
  2. **Government Securities Market** (Gilt-edged market).
  3. **Development and Financial Institutions.**  
This segment is primarily regulated by **SEBI**.