THE ROLE OF FINANCIAL INSTITUTIONS IN ECONOMIC DEVELOPMENT

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ABSTRACT

Today, the concept of economic development cannot be imagined without establishing & well-defined network & structure of financial institutions. The role of financial institutions is thus very crucial & important. This paper discuss importance of financial institutions in economic advanced..

Keywords: Financial institutions, Economic advancement & Catalyst role of financial institutions.

INTRODUCTION:

The need for establishing financial institutions was felt in many countries immediately after the Second World War in order to re-establish their war shattered economies. In under-development countries, the need for such institutions was much more due to a large number of organizational and financial problems inherent in the process of industrialization. As early as 1918, the Industrial Commission had recommended the establishment of a financial institution in India. After independence a number of financial institutions have been set up at all India and regional levels for accelerating the growth of industries by providing financial and other assistance required.

The financial institutions can be categorized as :
(a) All India Development Financial Institutions.
(b) The State Level Development Financial Institutions.
(c) The Insurance Companies.

THE PROBLEM STATEMENT:

The process of development cannot take place without proper institutional support & developmental inputs. It is necessary to evaluate the super & role of the financial institution. How there intuition contribute to the process of economic development & what is their role in the total process of economic change is the subject matter of this paper.

OBJECTIVES OF THE PAPER:

1. To examine the role of financial institutions in developmental activities of the economy.
2. To understand the pattern of contribution of financial and developmental institutions in economic development.
3. To examine the major challenges faced by the developmental banks & financial institutions.

Table 1.1 Indian Financial Institutions and Markets at a Glance

Item	Value (2002-03)	Value (2006-07)
1. Scheduled Commercial Banks (SCBs) (No.)	293	179
2. Public Sector Banks (PSBs) (No.)	27	27
3. Private Sector Banks (No.)	30	26
4. Foreign Banks (No.)	40	29
5. Regional Rural Banks (No.)	196	133
6. Scheduled Co-op. Banks (No.)	68	59
7. Scheduled Urban Co-op. Banks (No.)	52	53
8. Scheduled State Co-op. Banks (Nos.)	16	16
9. Deposit Accounts (No., Crores)	42.8	48.5
10. Loan Accounts (No., Crores)	5.2	15.13
11. Bank Branches (No.)	66186	71839
12. Urban Co-op. Banks (No.)	1826	1813
13. State Co-op. Banks (No.)	29	31
14. District Central Co-op. Banks (No.)	367	369
15. Mutual Funds (No.)	32	40
16. Mutual Funds Schemes (No.)	372	755
17. Non-Bank Financial Companies (NBFCs) (No.)	974	466
18. Stock Exchanges (No.)	24	23
19. Foreign Institutional Investors (No.)	502	997
20. Venture Capital Funds (No.)	43	45
21. Listed Companies (No.)	9644	6049
22. GDRs/ADRs (US $million)	131	3776
23. Foreign Capital Inflows (US $million)	9545	190
24. Average Daily BSE Turnover in July 2003 (Rs crore)	1434	3797
25. Average Daily NSE Turnover in July 2003 (Rs crore)	3429	12797
26. Development Financial Institutions (No.)	59	7
27. Life Insurance Companies (No.)	12	16
28. General Insurance Companies (No.)	12	15

Source : Bombay Stock Exchange, Annual Capital Market Review, 2002-03, pp. 10-12, RBI, RTPBI, Annual Report Various Issues.

SOME OTHER CONCEPTS OF DEVELOPMENT BANK:

"Financial Institution need not be passive instruments of economic activity. With dynamic management and an adequately permissive environment of available opportunities and favorable polices, they can be active engines of economic development.

William Diamond

"A development bank is like a living organism that reacts to its socio-economic environment and its success depends on reacting most aptly to that environment."

A. G. Kheradjou

In future, the participation and involvement of DFIs in the process of economic development will be still deeper as they intensify their efforts at the development of entrepreneurs, backward areas, small industries and export-oriented units as well as at the upgradation of technology in the traditional sectors. The tasks ahead are varied and challenging. Fresh demands may not only call for a substantial step up in resource mobilization efforts to keep pace with growth in the volume of financial assistance but may also require an orientation of the policies and priorities for allocation of assistance. Equally important will be the demands of multifarious promotional and developmental activities. Considering the strength and flexibility of the development finance system that has been built up over the years, the DFIs in India should be able to respond competently and adequately to future demands and add newer dimensions to the field of development banking.

These specialized financial institutions are also called Development Banks because they provided not only finances but also help in promotion of new enterprises. These institutions have to play a very significant role in the industrial development of our country for the following reasons:

(i) Absence of organized capital markets,
(ii) Lack of entrepreneurial taler'
(iii) Low capital formation,
(iv) Shyness of capital i.e. people prefer to invest only in traditional areas and are reluctant to take risk in new ventures.
(v) Inadequacy of financial facilities to meet huge requirement of funds for industrial development, and
(vi) Planned economic development to achieve the socio-economic objectives.

Table 1.2 Services Performed by Financial Intermediaries

Services Benefiting Suppliers of Fund

Monitoring Costs – Aggregation of funds in an FI provides greater incentive to collect
a firm's information and monitor actions. The relatively large size of the FI allows this collection of information to be accomplished at a lower average cost (economies of scale).

Liquidity and Price Risk – FIs provide financial claims to household savers with superior liquidity attributes and with lower price risk.

Transaction Cost Services – Similar to economies of scale in information production costs, an FI's size can result in economies of scale in transaction costs.

Maturity Intermediation – FIs can better bear the risk of mismatching the maturities of their assets and liabilities.

Denomination Intermediation – FIs such as mutual funds allow small investors to overcome constraints to buying assets imposed by large minimum denomination size. Services Benefiting the Overall Econom

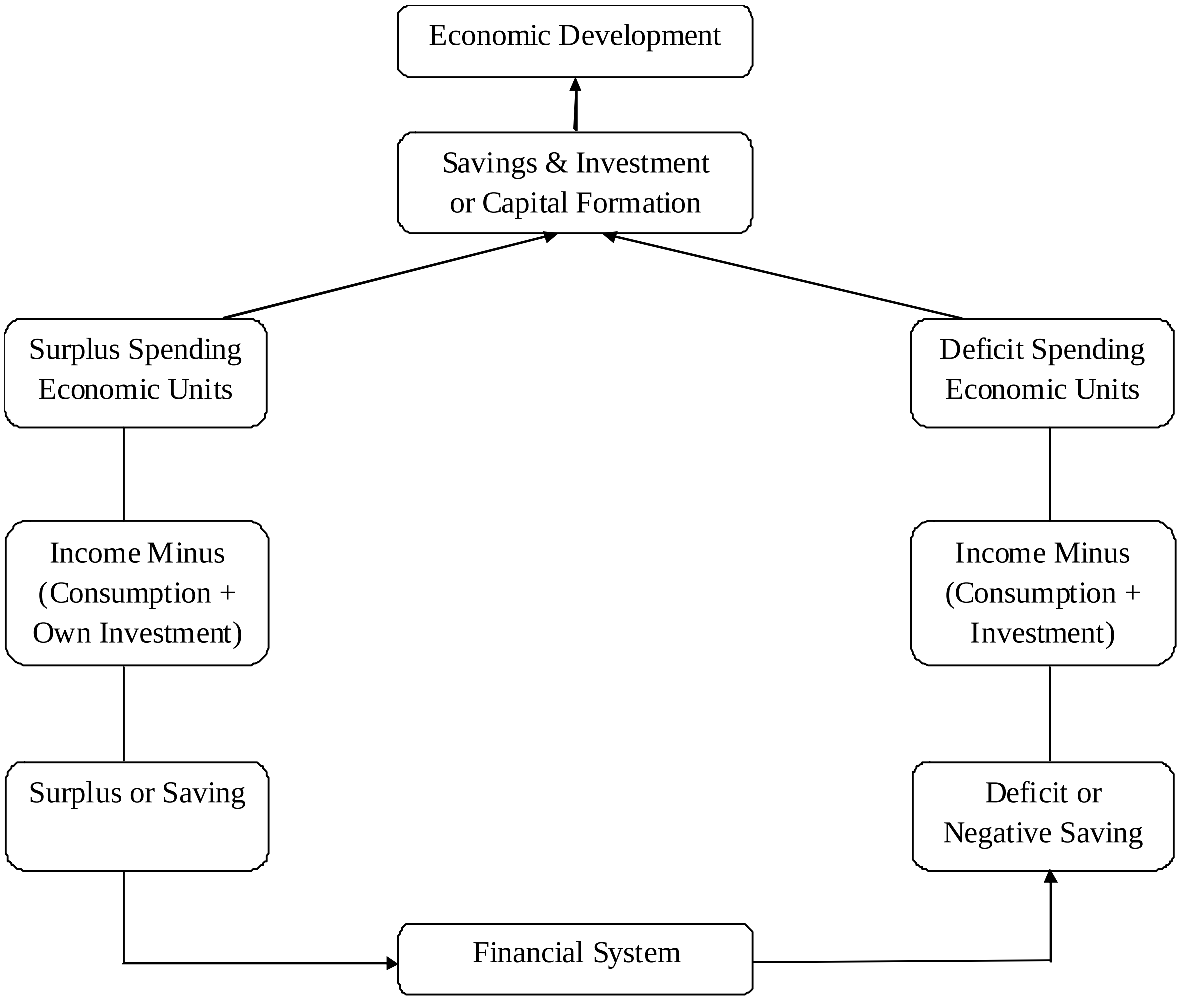
Money Supply Transmission – Depository institutions are the conduit through which monetary policy actions impact the rest of the financial system and the economy in general.

Credit Allocation – FIs are often viewed as the major, and sometimes only, source of financing for a particular sector of the economy, such as farming and residential real estate.

Intergenerational Wealth Transfers – FIs, especially life insurance companies and pension funds, provide savers with the ability to transfer wealth from one generation to the next.

Payment Services – Efficiency with which depository institutions provide payment services directly benefits the economy.

1.3 FINANCIAL INSTITUTIONS AND MARKETS:



Relationship between Financial System and Economic Development

At present there are four important financial institutions at the national level i.e. the Industrial Finance Corporation of India (IFCI). Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), The Industrial Reconstruction Corporation of India (IRCI) now called Industrial Investment Bank of India Ltd. (IIBIL). In addition, there are 19 State Financial Corporation's (SFCs) and 24 State Industrial Development Investment Corporations. Apart form these specialized financial institutions, Commercial Bank, Industrial Corporation, Small Industrial Development Corporation, Unit Trust of India, Life Insurance Corporations, National Industrial Development Corporation, etc. also provided finances for the development of industries in the country. Besides these institutions commercial banks provide short term as well long term finances. The Reserve Bank of India is also providing industrial finance through other financial institutions.

There are some international financing institutions like World Bank and its affiliates such as International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), International Finance Corporation (IFC) and Asian Development Bank (ADB). All these institutions also provide industrial finance, some through member countries while others directly to the enterprises. The help rendered by all such institutions has accelerated the pace of industrialization.

There are many advantages of raising loans from the specialized financial Institutions, such as :

(a) Availability of finance for development schemes.

(b) Reasonable security requirements.

(c) Availability of finance during periods of depression.

(d) Easy repayment facility

(e) Underwriting facility.

Such institutions help in promoting new companies; expansion and development of existing companies and meeting the financial requirement of companies during economic depression. The following are the sectors development by the financial institutions.

1. The Commercial Banking Sector

The greatest potential of the commercial banking sector is in its relationship with Small and Medium sized Enterprises, where Banks can be very influential through their lending practices and by providing information. Commercial banks have less influence over most larger companies. There is, however, scope for them to influence consumer behavior through the financial products they offer. To date the most commercial banks have focused on two areas : Firstly many have made considerable progress in developing internal environmental management systems to reduce their own environmental impact. Secondly, most banks include some environmental analysis into their credit assessment process although this tends to be focused on liability.

The United Nations Environmental Programme (UNEP) has established a statement on Banks and the Environment which over 90 banks have signed, including a substantial number from the EU. It is the leading international initiative on banks and environment and is certainly encourage a number of banks to take the environment seriously.

A smaller number of leading banks have taken their activities further, and for instance have started to take a wider view of environmental factors in credit assessment, including developing checklists and other procedures.

One particularly encouraging area of activity is providing practical support to small business on how to manage their environmental impacts, through information packs and other support.

Where banks have been less progressive is in developing new financial products with an environmental perspective for both business and individuals, such as energy efficiency loans. Encouraging the development of such products appears desirable. There has been considerable work in developing environmental management systems (EMS) and reporting for banks, including possibly an extension to EMAS. It is import that such initiatives focus on the environmental impacts of financial products rather than merely the impact of internal operations. In view of the generally systematic approach to business by commercial banks, further use of EMS appear to be an effective way forward for the sector.

2. The Investment Sector

The potential of the investment sector lies in the Influence it has over large companies. It can send signals to industry in the pricing of new capital of companies and in the on-going valuation of quoted companies as well as directly though the use of its rights as shareholders and owners.

To date, as whole, investors are probably less interested in the environment than bankers. However, a number of pressures are emerging on the investment sector:

- Leading companies have become increasingly frustrated with the failure of the investment community to recognize and reward the environmental progress they have made. In particular, the international business organization, WBCSD, has been active in this area, developing the concept of eco-efficiency and encouraging its use among investors.

- There is growing interest from individual investor in environmentally responsible investment, and this has led to the development of some progressive environmental investment funds. Institutional investors have also started to explore this area, reassured by the good investment performance of such funds. As a "green" product with no price or quality premium, the potential market for such products is likely to be substantial.

- Another avenue that some investors have pursued is shareholder activism. They have become frustrated with the indifference of investing institutions and are taking their concerns directly to large companies. This has proved effective in the US, but is more limited in Europe where shareholder' rights are less developed-there may be scope to develop it in the EU.

- Environmental NGOs have also stated to target fund manager and investment banks over their investments and involvement with environmentally damaging companies. To date they have not had major success, but have started to influence the sector.

- Finally, a few organizations among the investment sector have started to take environmental issues more seriously and may be creating some peer pressure for change. While much skepticism exists and should not be underestimated, there are signs that attitudes may be changing.

A key concern for the investment sector is the relationship between environmental performance and investment performance. Here the evidence on balance suggests that environmental performance does contribute to good financial performance. However, many in the investment sector remain unconvinced, and action is needed both to persuade doubters and reinforce signals, e. g. through the development of environmental taxation.

To encourage the investment sector to incorporate environmental issues a number of obstacles need to be overcome. Two key obstacles are market inertia in investment practices, and the balance between long term and short term analysis. However, the most important issue is probably difficulties in obtaining good quality information in ways that the sector can understand and use. Ways need to be found to provide relevant information to the sector.

Table 1.4 Risks Faced by Financial Institutions

1. **Credit Risk** – risk that promised such cash flows from loans and securities held by FIs may not be paid in full.
2. **Foreign Exchange Risk** – risk that exchange rate changes can affect the value of an FI's assets and liabilities located abroad.
3. **Country or Sovereign Risk** – risk that repayments from foreign borrowers may be interrupted because of interference from foreign governments.
4. **Interest Rate Risk** – risk incurred by an FI when the maturities of its assets and liabilities are mismatched.
5. **Market Risk** – risk incurred in trading assets and liabilities due to changes in interest rates, exchange rates, and other asset prices.
6. **Off-Balance-Sheet Risk** – risk incurred by an FI as the result of activities related to contingent assets and liabilities.
7. **Liquidity Risk** – risk that a sudden surge in liability withdrawals may require an FI to liquidate assets in a very short period of time and at low prices.
8. **Technology Risk** – risk incurred by an FI when its technological investments do not produce anticipated cost savings.
9. **Operational Risk** – risk that existing technology or support systems may malfunction or break down.
10. **Insolvency Risk** – risk that an FI may not have enough capital to offset a sudden decline in the value of its assets.

3. Companies, Investors and the Environment

Companies increasingly see environment issues as being of relevance to their business development, yet financial markets, particularly investors are uninterested. Companies are increasingly aware of the environmental pressures they are under and have developed a range of practical tools to address them.

There is increasing understanding of the financial implications of those pressures among leading specialists, yet most in the financial community pay only limited attention to them. Information is the key to financial evaluation, but there is limited useful information on environmental performance and management. The main existing sources of information are not geared to financial audiences.

- Environmental reporting is targeting multiple audiences and many companies do not report.
- The potential with annual reports is erratically exploited and lacks standardization.
- Publicly available information faces substantial practical obstacles.

To address this there is potential to develop standardized and financial useful environmental reports, potentially as part of the annual report, encompassing financial information, environmental performance data and qualitative information on environmental policy and management.

An alternative approach is through the development of environmental rating agencies who can provide a summary analysis geared to the needs of the financial markets. At present such services have only limited appeal, but they offer long term potential. An effective way of encouraging the development to these services would improve the quality of information made available though the public regulators.

In addition to the above, the banks and financial institutions also perform certain new-age functions which could not be thought of a couple of decades ago. The facility of internet banking enables customer to access and operate his bank account without actually visiting the bank premises. The facility of ATMs and the credit / debit cards has revolutionized the choices available with the customers. The banks also serve as alternative gate way for making payments on account of income tax and online payment of various bills like telephone, electricity and tax. The bank customers can also invest their funds in various stocks or mutual funds straight from their bank accounts. In the modern day economy, where people have no time to make these payments by standing in queue, the service provided by banks in commendable.

Financial institutions can respond quickly to new opportunities, particularly when the potential is presented to them in a clear and consistent manner, and although large, the financial needs of sustainable development in Europe are well within the scope of the European financial markets. However, inconsistent or ineffective policy development will send a negative signal to the market, and can results in adverse market sentiment against environment project, something which may have occurred over recent years.

4. Conclusion

Financial Institution have played major role in the economic development of the country and most of the credit-related schemes of the government to uplift the poorer and the under-privileged sections have been implemented through the banking sector. The role of banks and financial institution has been important, but it is going to be more important in the future. We have looked at the relationship between institutions and long run economic growth. This growing field of research may offer us a new insight into the dynamics of economic growth within and among various economies. In my presentation here today I have tried to motivation a new approach to modeling the role of financial institutions in long run economic growth by focusing the economic development made by financial institutions.

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