

Financial Systems

What are Financial System

A financial system is a set of institutions, such as banks, insurance companies, and stock exchanges, that permit the exchange of funds. They work together to exchange and transfer capital from one place to another. Through the financial system, investors receive capital to fund projects and receive a return on their investments. Financial systems exist on firm, regional, and global levels.



In simple words a financial system is all about taking money from someone who has ample of it and making it to reach those who have the best opportunities to utilise it. This way the economic resources are allocated most efficiently and best returns are ensured. Economic transactions are done by various organisations like banks, pension funds, organised exchanges and insurance companies and many more. They are the financial institutions who

use various financial instruments such as bonds, stocks, interests got on deposits, credit to the borrowers etc.

<https://corporatefinanceinstitute.com/resources/wealth-management/financial-system/#understanding-financial-systems>

not all money in the world is circulated exclusively through formal financial systems. While the vast majority of global money, especially the digital forms that make up over 90% of the total money supply, circulates through banks and other financial institutions, a significant portion of physical cash and other forms of value transfer occur outside these formal channels.

Components Of Financial Systems

Every financial system consists of multiple interlinked components that ensure smooth functioning:

- **Financial establishment:** Institutions like banks and insurance companies regulate and facilitate money exchange through deposits, loans, and risk coverage.
- **Financial instruments:** These include stocks, bonds, loans, and securities-assets that investors trade to generate returns.
- **Financial markets:** Platforms where financial instruments are bought and sold, supporting liquidity and economic growth.
- **Financial services:** Advisory, insurance, wealth management, and payment services that support individuals and business transactions.
- **Regulatory Bodies:** RBI, SEBI, IRDAI. They regulate, supervise, and ensure system stability.

Case study and Financial systems

Case Study: How the Financial System Helps a Small Business

Ramesh runs a small dairy business in a village. He saves ₹50,000 in a bank. Many other people also save money in the same bank.

The bank pools this money. It gives a loan of ₹3 lakh to Suresh, who wants to start a milk processing unit. Suresh buys machines and hires workers. Milk production increases. Local farmers get steady income. Suresh repays the loan with interest.

The bank pays interest to Ramesh and other savers. Savings become investment, Business grows, Jobs are created, Savers earn returns.

A financial system is the setup that manages money in an economy.

People save money. Businesses and individuals need money. The financial system connects the two. Because of this system, money does not stay idle. It flows to places where it is used productively.

Functions of financial Systems

1. Primary Functions

1. Savings Function (Mobilization)

- It encourages people to save by offering attractive instruments (FDs, Mutual Funds).
- Instead of keeping cash idle at home, savings enter the economy.

2. Credit Function (Allocation)

- It channels these savings to productive sectors (Industry, Agriculture, Infrastructure).
- Ensures capital goes to the most efficient users.

3. Payment Function (Liquidity)

- Provides a mechanism for making payments (Cheques, UPI, NEFT, RTGS).
- Makes exchange of goods and services easy without barter.

4. Risk Function (Protection)

- Provides protection against life and business risks (Insurance).
- Diversifies investment risk (Mutual Funds).

2. Liquidity Function

- The financial market (Stock Market) allows investors to sell their securities and get cash whenever needed.
- Without this, people would hesitate to invest in long-term projects.

3. Information Function

- Financial markets (like Stock Exchange) provide price information.
- This helps in valuation of assets and decision making.

Case Study: How the Financial System Transforms Savings into Economic Growth

Ravi earns ₹50,000 per month and saves ₹8,000.

1. Savings Mobilization - Ravi deposits money in a bank and invests via SIPs.

2. Credit Allocation - Banks lend this money to manufacturers, farmers, and startups.

3. Payment System - Digital payments via UPI and auto-debit EMIs.

4. Risk Management - Mutual fund diversification and business insurance.

5. Wealth Creation - Over 15 years, Ravi's wealth grows through compounding while businesses expand and create jobs.

Ravi never meets the borrower. The borrower never meets Ravi. The financial system connects them efficiently.