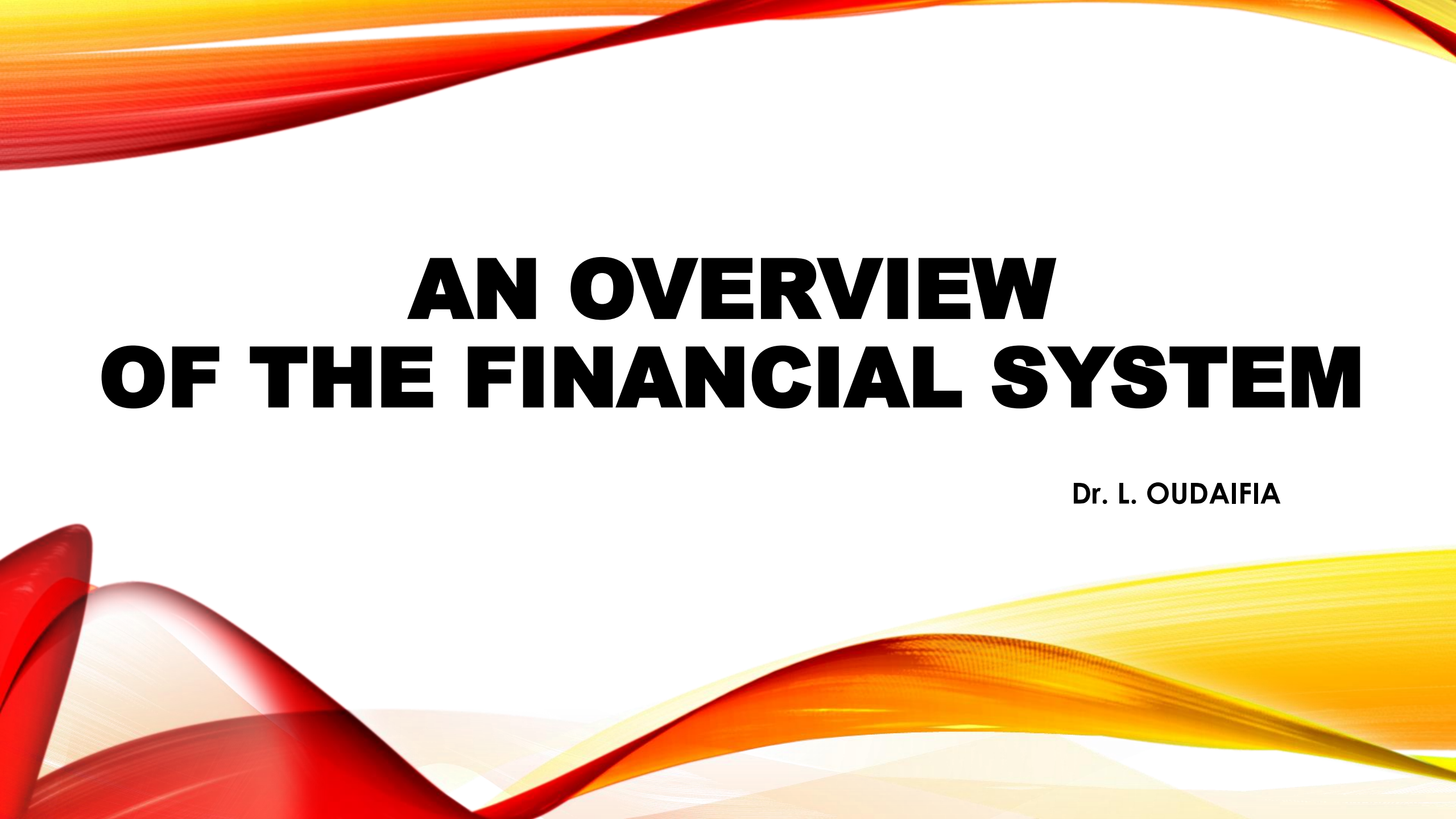
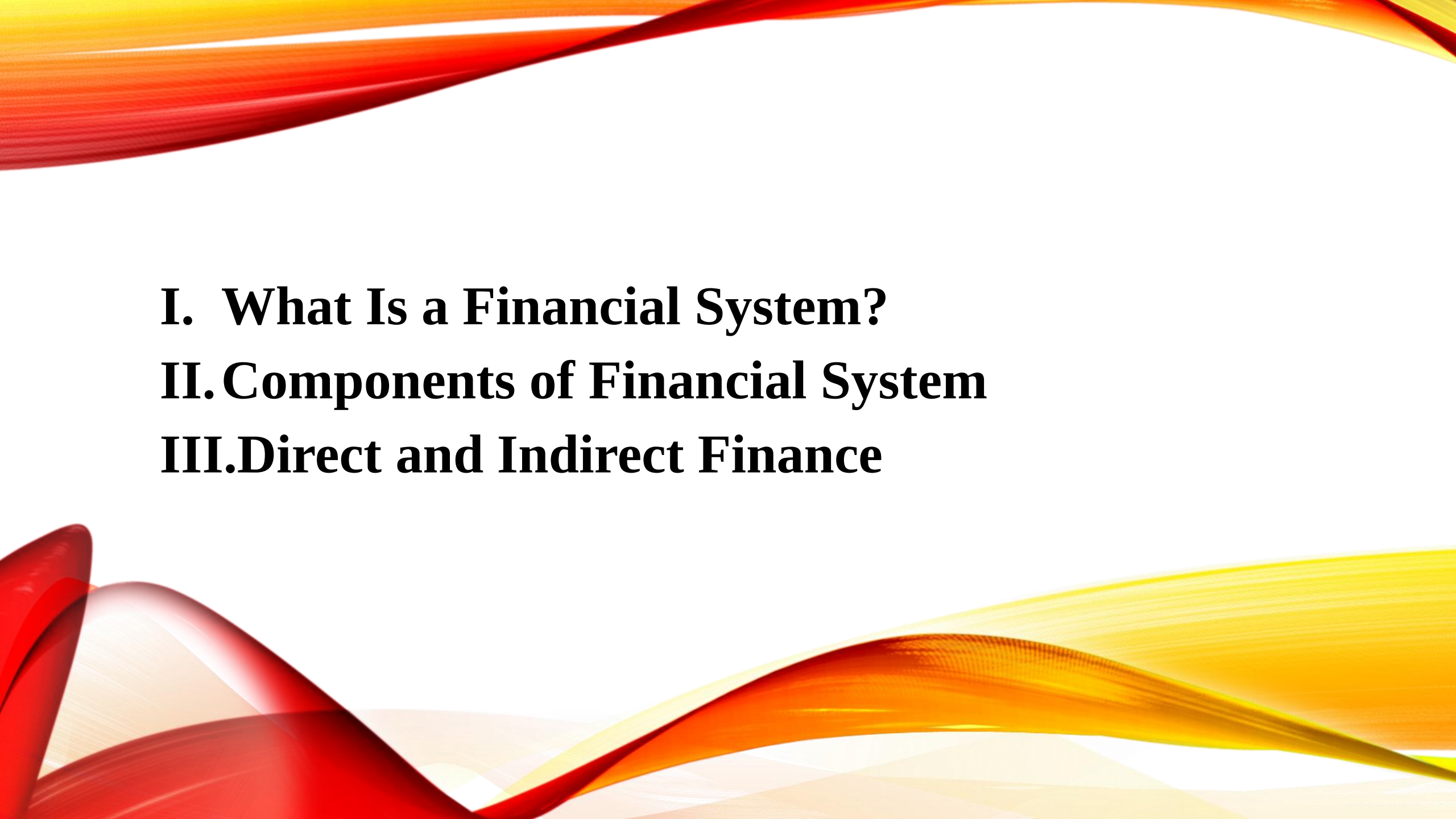




AN OVERVIEW OF THE FINANCIAL SYSTEM

Dr. L. OUDAFIA

- 
- I. What Is a Financial System?**
II. Components of Financial System
III. Direct and Indirect Finance



I. What Is a Financial System?

A financial system is a set of institutions, such as banks, insurance companies, and stock exchanges, that permit the exchange of funds. Financial systems exist on firm, regional, and global levels.

Borrowers, lenders, and investors exchange current funds to finance projects, either for consumption or productive investments, and to pursue a return on their financial assets. The financial system also includes sets of rules and practices that borrowers and lenders use to decide which projects get financed, who finances projects, and the terms of financial deals.

Components of the financial system



1

Financial institution

4

**Payment and
settlement systems**

7

**Financial
Infrastructure**

2

Financial markets

5

Regulatory authorities

8

Financial services

3

**Financial
instruments**

6

Central banks

1. Financial institution

The entities that provide financial services, such as banks, credit unions, insurance companies, investment banks, and pension funds, are called financial institutions. They act as intermediaries between savers and borrowers, channeling funds from savers to borrowers.

2. Financial markets

Financial markets are platforms where individuals, businesses, and governments buy and sell financial assets. Here are the various types of financial markets:

- Stock markets (for trading shares of companies), bond markets (for trading debt securities)
- Commodity markets (for trading commodities like gold, oil, etc.)
- Foreign exchange markets (for trading currencies)



3. Financial instruments

Financial instruments are monetary contracts that can be traded. Financial instruments include stocks, bonds, options, futures contracts, mortgages, and derivatives. Financial instruments provide a means for investors to invest their funds and for borrowers to raise capital.

4. Payment and settlement systems

Payment and settlement systems enable fund transfer between individuals, businesses, and financial institutions. It facilitates the clearing and settlement of transactions, ensuring that funds are transferred securely and efficiently.

5. Regulatory authorities

Governmental or independent regulatory bodies regulate all financial systems. These authorities establish rules and regulations to ensure financial markets and institutions' stability, transparency, and fairness. Additionally, these regulatory authorities protect consumers and investors from fraud, misconduct, and excessive risk-taking.

6. Central banks

Central banks are the monetary authorities of a country and sometimes for a group of countries. They are responsible for formulating and implementing monetary policy, controlling the money supply, and maintaining the financial system's stability. The Central banks also act as lenders of last resort to provide liquidity during financial stress.



7. Financial Infrastructure

Financial infrastructure is a technological system that supports the financial system's smooth functioning. Some examples of financial infrastructure include electronic banking systems, trading platforms, clearing and settlement systems, credit card networks, and more.

8. Financial services

The various services offered by financial institutions, such as loans, deposits, payment services, investment services, insurance services, financial advisory services, and risk management services, are termed financial services.

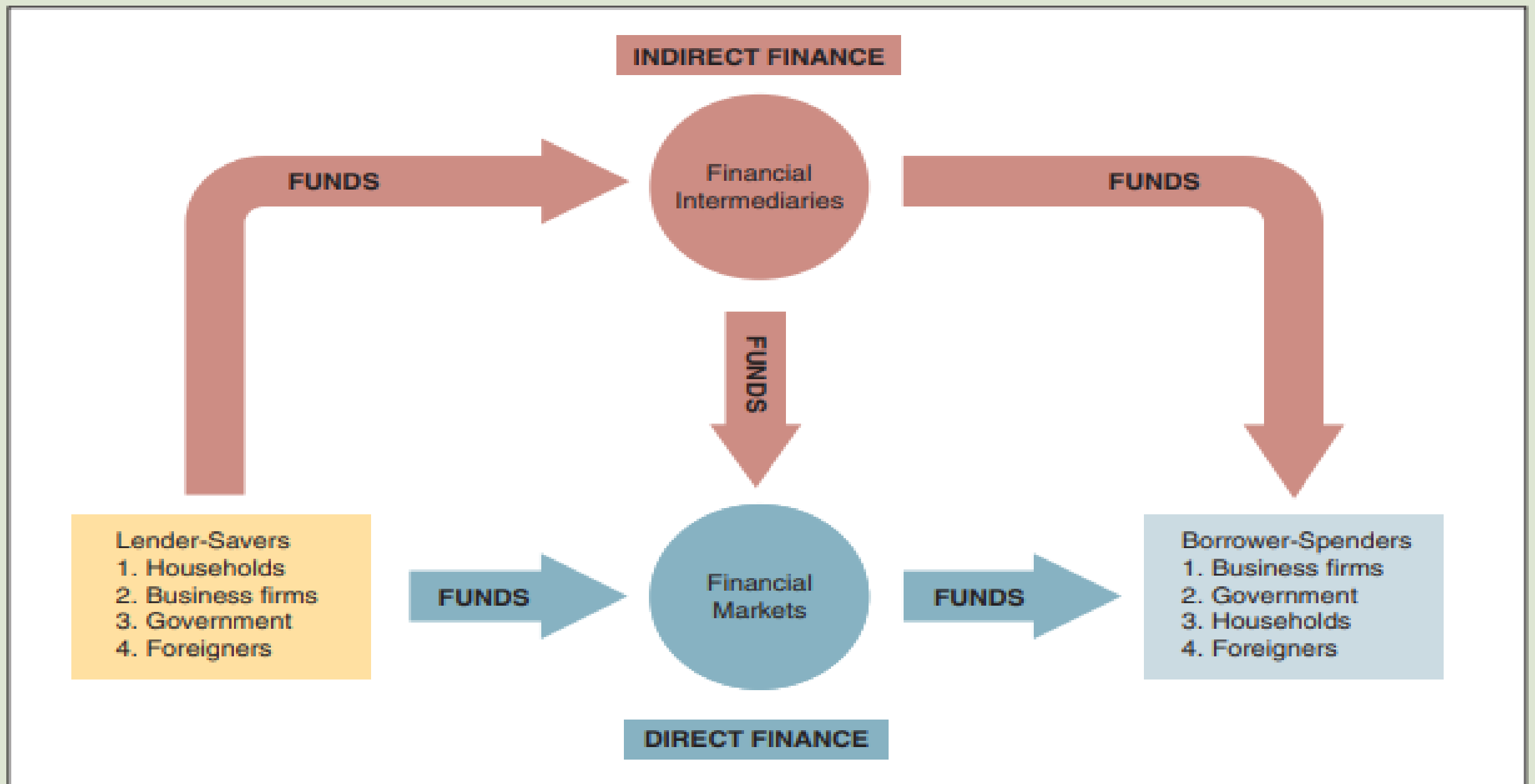


FIGURE 1 Flows of Funds Through the Financial System

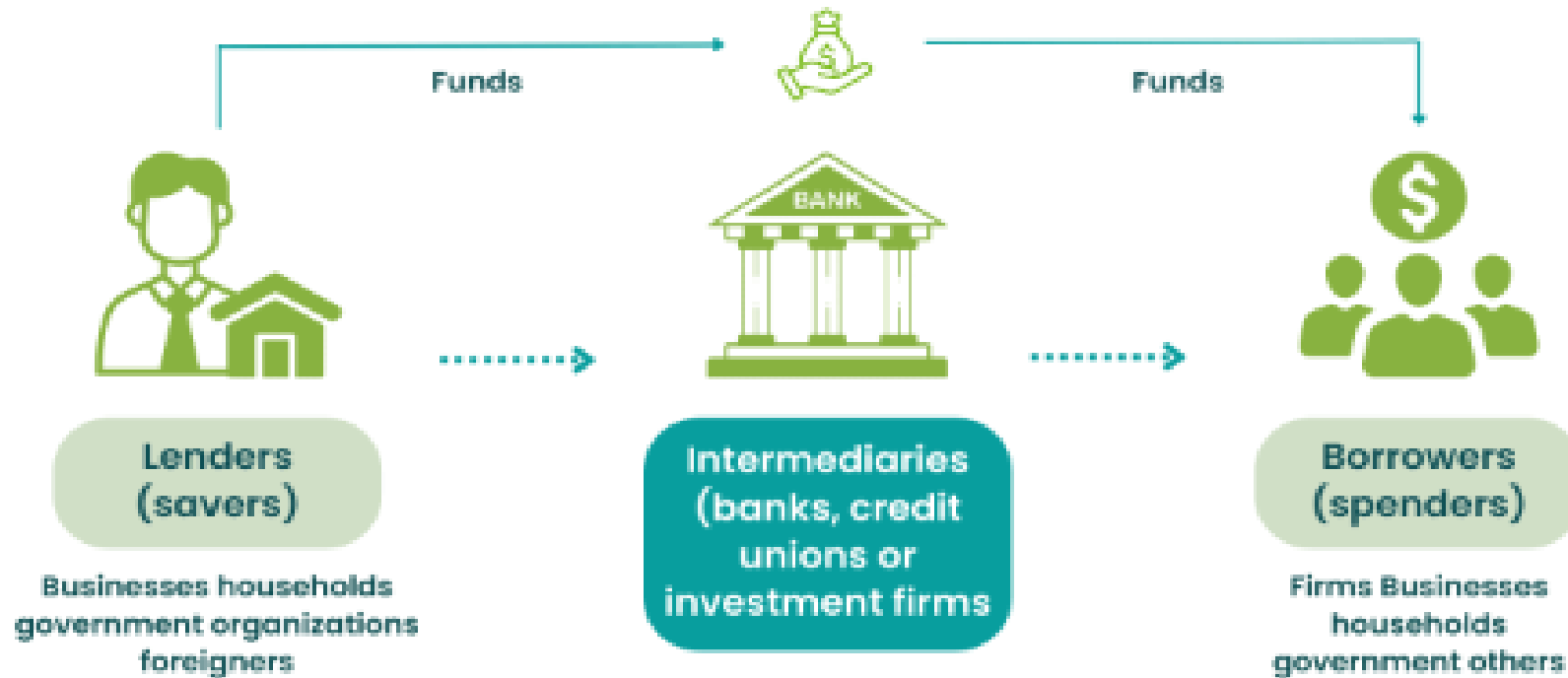


Financial markets perform the essential economic function of channeling funds from households, firms, and governments that have saved surplus funds by spending less than their income to those that have a shortage of funds because they wish to spend more than their income. Those who have saved and are lending funds, the lender-savers, are at the left, and those who must borrow funds to finance their spending, the borrower-spenders, are at the right. The principal lender-savers are households, but business enterprises and the government, as well as foreigners and their governments, sometimes also find themselves with excess funds and so lend them out. The most important borrower-spenders are businesses and the government but households and foreigners also borrow to finance their purchases of cars, furniture, and houses. The arrows show that funds flow from lender-savers to borrower-spenders via two routes



In direct finance (the route at the bottom of Figure 1), borrowers borrow funds directly from lenders in financial markets by selling them securities (also called financial instruments), which are claims on the borrower's future income or assets. Securities are assets for the person who buys them but liabilities (IOUs or debts) for the individual or firm that sells (issues) them. For example, if Ford needs to borrow funds to pay for a new factory to manufacture electric cars, it might borrow the funds from savers by selling them a bond, a debt security, that promises to make payments periodically for a specified period of time, or a stock, a security that entitles the owner to a share of the company's profits and assets.

Indirect Finance





Indirect finance is assistance of financial intermediaries or third-a method of raising capital for businesses and individuals with the party institutions. This approach is chosen primarily to secure funding while mitigating the risks associated with asymmetric information.

The significance of indirect finance extends to both households and organizations. Direct financing takes a back seat in this system as third-party intermediaries assume a pivotal role. This results in lower financing costs for consumers and provides access to specialized expertise. However, it is important to enhance the flexibility of indirect finance within secondary markets.

- 
- Indirect finance refers to financing where participants (borrowers) obtain funds from a third party rather than directly approaching primary lenders.
 - Borrowers in indirect finance can include both consumers and firms. Consumers typically use this financing to purchase products, while firms use it to fund their operations.
 - These financial intermediaries include depository institutions, credit unions, contractual savings institutions, and investment intermediaries.
 - Additionally, they provide financial services like denomination divisibility, liquidity, and flexibility in terms of maturity.

Indirect Finance vs Direct Finance

Although indirect and direct finance has the same participants, they operate in different markets. Therefore, it becomes necessary to understand the differences, so let us look at them:

Basis	Indirect Finance	Direct Finance
Meaning	Borrowers raise capital from financial intermediaries.	Individuals or firms borrow directly from the public.
Purpose	To raise capital without approaching investors directly.	To increase existing capital by approaching direct lenders.
Market	Operates in the secondary market through intermediaries.	Operates in the primary market, dealing directly with the public.
Example	Purchasing a car through a dealer with a dealer-facilitated loan.	A firm raises capital through an IPO directly from the public.

THANK YOU
FOR YOUR
ATTENTION