**The functions of financial institutions and markets in the economy**

A Financial market is a market in which financial assets/ securities such as stocks and bonds can be purchased and sold. Funds are transferred in financial markets when one party purchases financial assets previously held by another. Financial markets facilitate the flow of funds and thereby allow financing and investing by households, firms and government agencies (Madura, 2010). The flow of funds is depicted below;

Figure : Flow of funds in a financial system

Direct Finance

Indirect Finance

Financial institutions, also referred to as **financial intermediaries** like banks, mutual funds and credit unions (Sacco’s) pool savings from thrifty individuals and lend out the cash/ or invest the cash in investments. The central bank, on the other hand issues currency and coins among its other functions.

Financial intermediaries help lower **transactions costs** for the parties involved. This is achieved via economies of scale (for example, when a mutual fund pools cash from numerous small savers and invests on their behalf). In addition, the financial intermediaries employ **experts** who manage the portfolio on behalf of the investors. This can be illustrated using the following two examples; when a corporation wishes to raise funds, it may approach an investment bank that offers advice on how best to raise such funds, and goes further to assist in the raising such funds through filing the necessary legal documentation and underwriting the sale of such securities used to raise funds. Another illustration is when you invest in a mutual fund that is usually run by expert managers, which may result in superior returns.

Another reason why financial intermediaries’ are important in an economy is to do with the role of information in the market. Markets are characterized with **asymmetric information**, where one party is more knowledgeable about the other. When you take a loan from a bank, for example, you know better about your capability to repay as compared to the bank. This is the reason you may find it hard to lend some money to a colleague you are not familiar with. You never know whether they will ever pay back. To reduce this information asymmetry, you must gather information, and this will cost you money. As an individual, you may find that the returns you get from an investment will be less than the costs of gathering information regarding that investment. Because financial intermidiaries’ deal with huge amount of funds, they find it economical to gather information since the costs of gathering such information is lower than the returns expected. Thus existence of **information costs** is a major reason for existence of financial intermidiaries.

Information asymmetry manifests itself in two major ways; in the form of **Moral Hazards**, and **Adverse Selection (The lemons problem).** The students are expected to research on the meaning of the above two terms and how they relate to loans issued by commercial banks. (ASSIGNMENT 1).

The analysis of how asymmetric information problems affect economic behavior is called **agency theory.** Discuss the term agency theory, how it arises, its resolution, and how it affects financial structure of institutions/ markets. (ASSIGNMENT 2)

The figure below summarizes the functions of financial institutions and markets, highlighting the pivotal role that they play in the economy.

Figure 2: The financial system components and their financial functions

Adapted from: Mellicher and Norton (2003), *Finance: Introduction to institutions, investments and management,* John Wiley and Sons, Inc., USA.

1. Creating money

In Kenya, we have seen that it is The Central Bank of Kenya that issues notes and coins. Currency represents the most generalized claim to wealth, store of value, and so on. Without the currency, the economy would not be as vibrant as it is. There is need however to limit the amount of currency in circulation as too much money would result in inflation.

1. Transferring money

Why do people hold cash? They hold cash for transactions purposes, for speculative purposes and for precautionary purposes. When purchasing an item, you could pay for it through check. A check is simply an order to a bank to transfer the stated amount to the account of the payee. You could also request for an EFT to the account of the payee. Most people who subscribe to professional organizations or academic journals simply place a standing order. All of the above illustrate the role played by financial institutions in transferring cash.

1. Accumulating savings

Most Kenyans who are in formal and even informal employment are members of Saccos. They place a standing order to place to transfer a certain percentage of their salaries to the unions. People do this in order to build savings, and financial institutions help people accumulate savings in this way.

1. Lending and investing savings

Commercial banks, mortgage institutions and Saccos lend the cash to people who need it. Mutual funds pool resources from a wide range of investors and invest the cash in marketable securities and other investments. Thus financial institutions engage in the lending and investing of savings. By lending and investing savings, financial institutions help investors to have consumption timing- saving when there is surplus, and consuming the surplus saved once earning potential goes down.

1. Marketing financial assets

We discussed earlier that investment banks are involved in underwriting of securities. What is underwriting? The marketing of such securities is made possible by the existence of organized stock exchanges, and underwriters. This serves to allocate risk among investors depending on investors risk appetite.

1. Transferring of financial assets

Institutions such as organized stock exchanges and OTC markets for currencies allow for the transfer (Buying and selling) of assets. This is crucial in an efficient financial system.

1. Separation of ownership from management

For large organizations, shareholders elect a board of directors, which in turn hires and supervises the management of the firm. This structure means that the owners and managers of the firm are different. This gives the firm a stability that the owner-managed firm cannot achieve.

Modern economies may not function as they do without well organized and functional financial institutions and markets. This is the chief reason why governments are very keen to have a well functioning financial institutions/ markets systems- by instituting regulations, and even stepping in when there is instability.

**QUIZ**: Without transaction and information gathering/ processing costs, there would be no need for financial institutions and markets. Discuss.