CHAPTER 11 Financial Institutions

INTRODUCTION

Individuals, businesses and organizations deal in money and other financial assets such as shares, bonds, bills etc. for one transaction or the other. The purpose is to improve on their economic activities and make profits by trading in these assets. Financial institutions comprise of banks, insurance companies, stock exchange markets and other non-banking institutions. This chapter deals with money market institutions, capital market institutions as well as their various functions in an economy. It also discussed about the central bank and its obligations to the growth of the economy.

OBJECTIVES

At the end of this chapter, students should be able to:
- Define money and capital market;
- Identify types and functions of financial institutions;
- Explain types and features of securities;
- List the benefits of a capital market;
- Explain the process of and requirements for accessing capital markets.

11.1 Definition of Financial Institutions

Financial institutions are business organizations that deal in money. They provide financial services to their customers. One of the most important functions of financial institutions is that they act as intermediaries or middleman.

11.1.1 Traditional Financial Institutions

There are a number of traditional financial institutions which have existed before the advent of modern money market. These traditional financial institutions performing basic traditional functions and they work alongside the modern banking business in today's economic activities. Such traditional financial institutions engaged in lending and charge relatively high interest rates. In Nigeria, traditional financial institutions are organized into different forms and have different names such as Esusu, Ajo, Asusu, Isusu, Adashi, etc. Members of these various bodies lend money to each other from their various contributions on an agreed period.

11.2 Money Markets

Money markets are forms of markets where actions, such as; short-term lending and borrowing of money are transacted. The major institutions involved in the money market are the banks.

11.2.1 Banks

A bank is a financial institution where money and other valuables such as jewelries, certificates etc are kept for safe custody. There are different types of banks. They include: Commercial banks, merchant banks, development banks and of course the central bank which is also referred to as the bankers' bank or the government bank.

11.2.1.1 Commercial Banks

Commercial banks are banks that accept deposits and valuables from the public for safe keeping. They are profit-oriented institutions. They serve as banks to individuals, government and corporate organizations.
Commercial banks are limited liability companies. Examples of commercial banks are First Bank of Nigeria Plc, Union Bank Plc, Mainstreet Bank Plc, Guaranty Trust Bank Plc etc.

Functions of commercial banks

Commercial banks as joint stock companies perform the following functions:

a. **Accepts cash deposit:** Commercial banks provide facilities for safe-keeping of money for their customers which may be kept in either current, savings or fixed deposit accounts.
b. **Lending:** Commercial banks act as lending agent by making short term loans available to their customers.
c. **Making of payment:** Commercial banks act as agents for making payments on behalf of their clients.
d. **Keeping of valuables:** Commercial banks help in keeping valuables such as gold and jewelries, certificates etc for their customers.
e. **Acts as trustee and executors of will:** Commercial banks manage the assets of the deceased and distribute the assets among his family members according to his written will.
f. **Acts as investment advisers:** Commercial banks offer both managerial and technical advise to their business partners.
g. **Executing government policies:** Commercial banks perform the function of carrying out government's policies through the directive of the central bank.
h. **Facilitates foreign trade and travels:** Commercial banks issue travelers cheques to customers who travel outside the country and help them to obtain foreign exchange thereby enhancing internationals trade and business.

Problems of commercial banks

a. **Concentration in urban centres:** Most commercial banks are concentrated in the urban centres. This limits the access of the rural dwellers and thereby hampers rural development.
b. **Limited abilities to create money:** Due to high poverty rate, there is low savings in banks, which limit money creation.
c. **High levels of illiteracy:** High levels of illiteracy lowers the savings culture of people.
d. **High interest rates:** The higher the interest rate, the lower the request for loans and overdrafts.
e. **Capital shortages:** Most commercial banks complain of shortage of capital.
f. **Corruption:** There is a high level of financial imbalance in most commercial banks because of corruption.
g. **Lack of innovative banking practices:** Most of the commercial banks are not innovative in their banking practices to enable customers are given the prompt attention they desire.

11.2.1.2 The Central Bank

A central bank is a government owned bank which controls and supervises the monetary and financial system of a country. It is the apex bank that regulates, directs, assists and coordinates the operations of other financial institutions so as to make them comply with the monetary and economic policies of the government. Such policies may include the regulation of money supply, control of credits, etc. The Central Bank constantly monitors the performance of the economy with a view to keeping the financial structure in proper balance.

Functions of a central bank

1. **Bankers bank:** Central bank is a banker's bank. It receives and keeps liquid assets for commercial banks and other financial institutions. Central Bank makes it possible for commercial banks to settle their indebtedness to one another by providing clearing facilities.
2. **Lender of Last Resort:** Central bank acts as the lender of the last resort to commercial banks when they (the commercial banks) run out of money to meet their financial obligations to their numerous customers.
3. **Issuing of currency:** The central bank is the monetary authority empowered by law to issue bank notes and coins within the economy. The central bank has the power to put into circulation if need be and it also ensures the withdrawals of old currencies in the economy.
4. **Maintenance of monetary stability:** The central bank ensures the stability of the country's financial system through the use of various instruments. Some of the instruments used by the central bank are the Open Market Operation (OMO), bank rates, bank directives, cash deposit ratio etc.
5. **Acts as government's bank:** One of the important functions of the central bank is that it acts as the government's bank. The central bank keeps account on behalf of the government by receiving all financial proceeds on behalf of the government.
6. **The central bank transacts foreign business on behalf of the country:** It deals with the central banks of other countries and with other international financial organizations such as the World Bank, IMF etc. The bank manages the country's external assets and liabilities and manages the country's gold and foreign reserves, receives foreign exchange earnings of the country. The central bank tries to maintain a favourable balance of payment for the home country.
7. The central bank helps government to raise loans for economic development

11.2.1.3 Control of Commercial Banks by the Central Bank

The central bank controls commercial banks through the use of various instruments. These are:

a. **Open market operation:** This refers to the buying and selling of government securities such as treasury bills and bonds from and to the public or business organizations. If the quantity or volume of money in the circulation is too high, the central bank could reduce the quantity in an attempt to control for inflation by selling bonds or treasury bills to the public and financial institutions. This will in turn reduce the money in circulation as the securities will be offered in return for cash or cheque from the public financial institutions. Similarly, if the amount of money in circulation is small, the central bank also uses this tool by buying from the public or financial institutions and offer cash for the purchase of these securities. This will in turn increase the lending power of the financial institutions.

b. **Cash-deposit ratio:** This is the minimum legal reserve requirements of the commercial banks to the central bank. It relates the ratio of their cash reserve to their total deposit liabilities. The central bank can use the cash-deposit ratio to either increase or reduce the money in circulation. If the money in circulation is too much, the central can increase the commercial bank cash deposit ratio thereby reducing the cash balance of the commercial banks. This will subsequently reduce their (commercial banks) lending power.

c. **Use of bank rate: The** bank rate is the rate at which the central bank discounts or re-discounts bills of financial institutions. It is the rate at which the central bank lends money to the banks or financial institutions. The central bank can increase the bank rate to curb inflation. This will compel the commercial banks to increase their interest rate per lending to the public and businesses.

d. This will in turn discourage borrowing by the public and organizations thereby lowering the volume of money in the circulation. This instrument can also be used to increase the volume of money in circulation through the reduction in the bank rate to the banks by the central bank.

e. **Use of moral suasion and directives:** The central bank can control the money supply in an economy through either direct order to the commercial banks or appealing to their sense of reasoning through what is known as 'Moral suasion'. It is an appeal by the central bank to the commercial banks towards paying special attention to specific monetary habit which may or may not be in the interest of the economy. The central bank can also give directives to commercial banks on certain areas they (commercial banks) could concentrate their lending or otherwise.

f. **Use of special deposits:** These are special additional deposits which the central bank may request the commercial banks to keep with it. It is most often used to keep down the rate of inflation if the cash-deposit ratio is inadequate to control inflation in the economy.

11.3 Capital Markets

Capital market is a financial institution established to provide long term financial assets. It is a market for long-term loans. It consists of people and organizations willing to lend out money on long-term basis.
Examples of such financial institutions which operates in the capital market are mortgage banks, development banks, insurance, merchant banks, stock exchange markets etc.

11.3.1 Merchant Banks

A merchant bank is a wholesale bank which deals in large sum of money. Its main function is issuing shares and discounting as well as accepting bills.

11.3.1.1 Functions of Merchant Banks

a. Issues new shares: Merchant banks issue new shares of companies to the public in order to raise capital.
b. Underwriting shares: They guarantee buying of share that may not be subscribed to by the public.
c. Accepts bill of exchange.
d. Provision of medium and long-term loans.
e. Provision of financial and technical advice.

11.3.2 Development Banks

A development bank is a financial institution which provides long term capital for investment in specific areas of the economy such as industry, agriculture and commerce.

11.3.2.1 Functions of Development Banks

a. Provision of long-term capital for investment.
b. Direct investment: Development banks invest directly in productive sectors of the economy such as industry and commerce.
c. Offering of financial and technical advice.
d. Development banks conduct research(es) in relevant areas of the economy.

11.3.3 Mortgage Banks

A mortgage bank is a financial institution which is established to provide long-term loans for building of houses. Example of mortgage bank in Nigeria is the Federal Mortgage bank.

11.3.3.1 Functions of Mortgage Banks

a. Provision of long-term housing loans.
b. Acceptance of money deposits.
c. Provision of advice to investors.
d. Execution of government housing policies.

11.3.4 Insurance Companies

An insurance Company is a financial institution which receives premiums and enters into contract with individuals and organizations.

11.3.4.1 Function of Insurance Companies

a. Pooling of risk: They insure paid premium which is pooled into funds.
b. Boost expansion of commercial and industrial banks.
c. Provides capital for investors.
d. Provides advice to their customers.
e. Engages in direct investment.

11.3.5 The Stock Exchange Market

The stock exchange market is a market which deals with the buying and selling of long-term financial assets. There are two main dealers in the stock exchange market. These are the broker who deals directly with the public and the jobbers who is the main dealer in the stock exchange.
The broker buys and sells securities on behalf of their customers and also offers them advice. They charge commission for the transactions. The jobber on the other hand does not deal with the public but with broker.
The jobber buys and sells securities to the broker. He charges higher price for selling and lower price for buying. The difference between his selling and buying price is the jobber’s profit which is known as the jobber’s turn.

11.3.5.1 Functions of the Stock Exchange

a. Raising of long-term capital for investment
b. Easy marketing of long-term securities
c. Protect the public against fraud
d. Offering of investment opportunities for those with little income
e. Acts as means of measuring the performance of businesses in an economy.

Summary

This chapter has discussed:

- Financial institutions which are very important actors in any economy of a country. A financial institution of a country comprises of the central bank which is the apex bank of the country.
- The central bank which controls and regulates the activities of other financial institutions (banks and non-bank business) in the economy.
- The central bank is referred to as the government bank which transacts business on behalf of the government either within or outside the country. The commercial banks which are examples of bank which operates in the money market, while other financial institutions such as the development bank, finance corporations, stock exchange are the major economic agents which operate in the capital market.
- **A capital market** is a financial institution which deals in long-term financing, while the money market deals in short-term financing.
- **A bank** is a financial institution where money and other valuables such as gold and certificates are kept for safe custody. The functions of the

banks among others include:

- Accepting deposits from its customers
- Provision of financial and technical advice
- Transacts business on behalf of its customers
- Lending to improve the customer's business

Class Activities

Identify any commercial bank near your school community and request for why they most times increase their interest rates to would be investors. Also find out how they help small businesses to grow.

Revision Questions

Objective Questions

1. Open market operations are the process by which:
(a) The central bank purchases and sells securities
(b) Commercial banks purchases and sell securities
(c) Business firms buy raw materials freely
(d) Households buy consumer goods openly
(e) The money market takes over the function of the central bank **(SSCE 1991)**
2. Which of the following is not a function of the central bank?
(a) Banker to the government
(b) Banker's bank
(c) Acceptance of deposits from the public
(d) Responsibility for monetary policy
(e) Lender of last resort **(SSCE 1992)**
3. The central bank controls commercial banks through all the following measures except:
(a) The use of directives
(b) The use of bank rate
(c) Open market operations
(d) Accepting deposits
(e) Demanding special deposits **(SSCE 1994)**
4. Which of the following is specialized in lending money for the purpose of developing real estate?
(a) Merchant banks
(b) Mortgage banks
(c) Discount houses
(d) Commercial banks **(SSCE 2009)**
5. Which one of the following serves as a banker's bank?
(a) Central bank
(b) Commercial bank
(c) The Mortgage bank
(d) Development bank **(SSCE 2009)**

Essay Questions

1. (a) Discuss the roles of commercial bank to the economy of your country.
(b) Explain how central bank controls the activities of commercial banks.
2. Write short notes on the following:
(a) Money market
(b) Capital market
(c) Stock exchange market
3. (a) Distinguish between

(i) mortgage bank and a merchant bank
(ii) commercial bank and a development bank
(b) Explain any **four** functions of commercial bank **(SSCE 2004)**
4. (a) What is a commercial bank?
(b) Describe any **four** ways by which the Central Bank controls the amount of credit given by the commercial bank (**SSCE 2010)**

Glossary

Money market: This is a type of market or financial market that provides short-term finance for investment. They bring short-term borrowers and lenders together. The short-term period is usually within a period of three months. Examples of money markets are commercial banks, merchant banks, discount houses etc.
Capital markets: These are financial institutions which issue long-term financial assistant to their clients. It is a type of markets which provides both medium and long-term finance for investment. Examples of capital markets are insurance companies, development banks, stock exchange markets etc.
Central bank: The government bank which is responsible for the control of other banking activities. It is the issuing authority responsible for the issuing of currency (notes and coins) in any economy.
Securities: These are trading instruments used in business. They are in form of investment instrument used in the cause of business. Examples of such securities are bonds, shares, bilk etc.