ISSN 2349-7807

International Journal of Recent Research in Commerce Economics and Management (IJRRCEM)
Vol. 12, Issue 1, pp: (1-12), Month: January - March 2025, Available at: www.paperpublications.org

THEORY OF FINANCIAL INTERMEDIATION: A MILLENIAL PERSPECTIVE OF THEORY AND PRACTICE

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DOI: https://doi.org/10.5281/zenodo.14677499

Published Date: 17-January-2025

Abstract: **Financial intermediaries, according to the theory, have to function only because financial market are not perfect, which spells out their intermediation process towards profitability and growth attainment. This study aided to depicts the importance of financial structure in intermediation process, the two broad categories of intermediaries, the two perspectives intermediaries are expected to function, theory of financial intermediation and related theories the mirrors out the process, how and why they must be regulated at interval and the functions of intermediaries towards household, firms and government.**

Keywords: **Financial intermediaries, financial market, growth attainment, financial structure.**

1. HISTORY OF FINANCIAL INTERMEDIARIES

Banking Regulatory history date back centuries ago, to the code that Hammurabi used to regulate the grain loans, Athens, under the solom legislation, demolished the slavery as a medium of debt repayment. Earlier in Sparta under the Lycurgus legislation, administrative barriers had been placed to discourage the use of money. Excessive profit were highly disapproved by ancient Greek society and religion, as understanding in Midas story. Even though banking reputation appeared much later. In the medieval Europe, the original banks were "MERCHANT BANKS"

In 1156 in venice, the first bank was established with a guarantee from the state. It purpose was to facilitate Roman Catholic Church crusades and Venetian territory expansion wars. In the middle of 13th century, group of Christian based in Italy invented legal work around to the Christianity ban on usury, among them are the famous bank of Medici and the Banca Monte Dei Paschi Siena founded in the Republic of Siena as di Pieta 1472. In the early 1400, the magistrate of Barcelona established in the city the First Bank, based on the Venetian model for exchange and deposit under the name "TanuladeCanvi".

In the 16th century, Marrano Jew from Iberia introduced the technique of Europe of capitalist, banking and the mercantilist concept of the state economy to the Ohoman Empire. The Bank of Venice was the first National Bank within European boundaries established in 1117. The famous Central Bank of England was founded by Charles Montage. All this historical development where narrowed down to the desire to gain interest and profit for trade transaction. This propelled the colonial Master to come down to Nigeria in search Green pastures. This green pastures craving made them explore the black race which was a betterment to a part and a cause to the populace of the country. The education and enlightment gained by the populace and the gain of independence for Nigeria had a major influence on the economic and financial sector of the country.

The banking sector, being an intermediary in any economy have a major role they play in enhancing development and growth through their activities of (a) Mobilizing saving, identifying good investment and exerting through sound corporate control, particularly during the early stages of economic development and weak institutional environment. The banks role are (i) acquiring information about firms and managers and thereby improving capital allocation and corporate governance (Diamond 1984; Ramakrishnan and Thakur) (ii) Managing cross-sectional inter-temporal and liquidity risk and thereby enhancing investment efficiency and economic growth. (Allen Gale, 1999; Bencivega and Smith, 1991) and (iii) mobilizing capital to exploit economic of scale (Sirri and Tufano, 1995).

The efficiency of banking institution in which they operate depends on two key factors of;

(1) Degree of competition that exists among the institutions and

(2) The nature of the regulation to which they are subject to.

It is believed that a competition will result in greater technical efficiency within deposit institutions, lower interest rates for borrowers, higher interest rates for depositors and a greater variety of services – all which will be of more than in most other sector of the economy, regulations shapes the nature of banking activities. It has been observed that the adoption of a "functional" approach to regulation would best fulfill the needs of an economy for intermediary services assuring the competitive, flexibility and Innovation necessary for a smooth financial system. There is a real danger that banks would operate in a highly inflationary manner if they were free of official control.

Moreover, this money creating and money destroying activities might be such as to accentuate cyclonical fluctuation. Such daggers are so great that the creation of money by commercial banks has to be subjected to limitation and regulation in practically every country. This distinctive factor that shows the efficacy of intermediaries towards economic development is a distinguishing fact.

1.1 INTRODUCTION

The financial system as well as it financing mode constitute a most effective in the industrialization process of most countries that are now economically developed, or effective working toward economic growth and development. The cogent function of the financial systems is to channel savings to those who wish to make fund investments. The financial system should inter alia (middleman), facilitate the leading of funds from savings to those who wish to undertake investment in capital goods and also companies or individuals that wish to finance investments projects. In order to attain a well-functioning financial system (Bank-based or market based), then some economic problem that challenges the growth and development of Nigeria. This study will be narrowed to the theory of financial intermediation (institutional and functional perspectives),why are financial intermediaries relevant, why financial intermediaries must be regulated, function of financial intermediaries and various forms, and other related theories the aid the proper execution of intermediation process

However, development is a highly complex process by economic and non-economic factors, and the rate of capital accumulation as well as how utilized is a major determinant of growth. This development can either be supply leading or demand following movement which was depicted by Patrick (1966). Supply leading development can be depicted when development of an economy is triggered by the interrelationship of the **FINANCIAL SYSTEM** towards the real sector of the economy.

A financial system comprises financial institutions, financial markets, financial instruments, rules, conventions, and norms that facilitate the flow of funds and other financial services within and outside the national economy. it also includes the environment of and regulations governing the interaction of the different categories of the institutions among themselves and with others. Okigbo (1981). The financial system or sector is wed of organized and regulated financial interrelationship among financial intermediaries and market. As Revell (1973) argues, financial institutions and financial market are not the whole of financial system, and they are not even an essential feature of any financial system. He further contends that "the essential feature of any financial system consists of a number of financial inter-relationships between the persons and bodies that make up an economy, and the basic structure of a financial system has three features;

- The extent of these inter-relationships
- The forms of financial claims in which the inter relationship are expressed; and
- The pattern of relationship between persons and bodies of different kinds, between independent economic units.

A financial system is a super structure erected on the basis of wealth of an economic system. Goldsmith (1969) refers to this as the relationship between the super structure (a set of financial institutions, intermediaries and instruments and instruments) and financial infrastructure (real wealth or national income).This ratio is known as financial inter-relation's ratio. it is a ration that shows the extent of performance among the financial intermediaries and institutions.

1.2 FINANCIAL STRUCTURE AND ECONOMY.

The importance of financial structure as catalyst in economic development is both widely agreed by the both the monetary and development economists. in facts the need to develop domestic financial structure and patterns of behavior necessary to generate and mobilize scarce capital funds as key conditions to economic growth and development originated has unique work by Schumpeter (1934). A financial structure assists in the creation of the types of assets that both the banking and non-banking public wish to hold from, the kind of financial liabilities that debtors are willing to incur. Consequently, if well managed and adapted efficiently, a countries financial system can play an important role in an economy's developments.

However, different countries have various model of structure pertaining to the model that suits their present economic needs and desire. A components and vehicle the bridge and at the same time propel economic growth in an economy is the financial intermediaries and market which are parts of the financial structure of any economy. Basically, because of their allocative and distributive prospects to enhance growth (Levine 1997).By involving in financial intermediation which is done by acting on the saving rate, on the fraction of saving channeled to investment or on the social marginal productivity of investment which will affect the growth of the economy. In general, financial development will be positive for economic growth. But some improvements in risk-sharing and in the credit market for households may decrease the saving rate and, hence, the growth rate (Pagano, 1993).

There are different views on how the financial structure affects economic growth exactly (Levine, 2000).

- The bank-based view holds that bank-based systems – particularly at early stages of economic development – foster economic growth to a greater degree than market-based systems.

- The market-based view emphasizes that markets provide key financial services that stimulate innovation and long-run growth.

- The financial services view stresses the role of banks and markets in researching firms, exerting corporate control, creating risk management devices, and mobilizing society's savings for the most productive endeavors in tandem. As such, it does regard banks and markets as complements rather than substitutes as it focuses on the quality of the financial services produced by the entire financial system.

- The legal-based view rejects the analytical validity of the financial structure debate. It argues that the legal system shapes the quality of financial services (for example La Porta et al., 1998). The legal-based view stresses that the component of financial development explained by the legal system critically influences long-run growth. Political factors have been introduced too, in order to explain the relationship between financial and economic development (see Fohlin, 2000; Kroszner and Strahan, 2000; Rajan and Zingales, 2000).

From empirical research of the relationship between economic and financial development, it appears that history and path-dependency weigh very heavy in determining the growth and design of financial institutions and markets. But it is important to realize that efficient financial intermediation confers two important benefits: it raises the level of investment and savings, and it increases the efficiency in the allocation of financial funds in the economic system, that is evident in any economy that make both the bank-based and market-based structure a complements, rather than substitute in-order to foster both economic and financial development.

2. CONCEPTUAL REVIEW

2.1 FINANCIAL INTERMEDIARIES

Financial intermediary; is a special financial entity, which performs the role of efficient allocation of funds, when there are conditions that make it difficult for lenders or investors of funds to deal directly with borrowers of funds in financial markets. Financial intermediaries include depository institutions, insurance companies, regulated investment companies, investment banks, pension funds. They are financial institutions specialized in the activity of buying and selling (at the same

time) assets and financial contracts. As their name suggests, financial intermediaries mediate between the providers and users of financial capital. The transfer of funds from surplus spending unit to deficit spending unit through financial intermediaries is also called is called **FINANCIAL INTERMEDIATION.** The various financial intermediaries categorized into two are as follows;

- Banking Financial institutions (bank-based system).
- Non – Bank Financial institutions (market –based system).

2.1.1 Banking Financial institutions (bank- based system)

A **bank** is a financial intermediary that creates credit by lending money to a borrower, thereby creating a corresponding deposit on the bank's balance sheet. Lending activities can be performed either directly or indirectly through capital markets. Due to their importance in the financial system and influence on national economies, banks are highly regulated in most countries. Most nations have institutionalized a system known as fractional reserve banking under which banks hold liquid assets equal to only a portion of their current liabilities, in Nigeria this responsibility is done by the CBN (Central Bank of Nigeria). In addition to other regulations intended to ensure liquidity, banks are generally subject to minimum capital requirements based on an international set of capital standards, known as the Basel Accords.

2.1.2 Non- Banking Financial institution (market-based institution).

A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. NBFIs facilitate bank-related financial services, such as investment, risk pooling, contractual savings, and market brokering. Examples of these include insurance firms, pawn shops, cashier's check issuers, check cashing locations, payday lending, currency exchanges, and microloan organizations. Alan Greenspan has identified the role of NBFIs in strengthening an economy, as they provide "multiple alternatives to transform an economy's savings into capital investment (which) act as backup facilities should the primary form of intermediation fail."

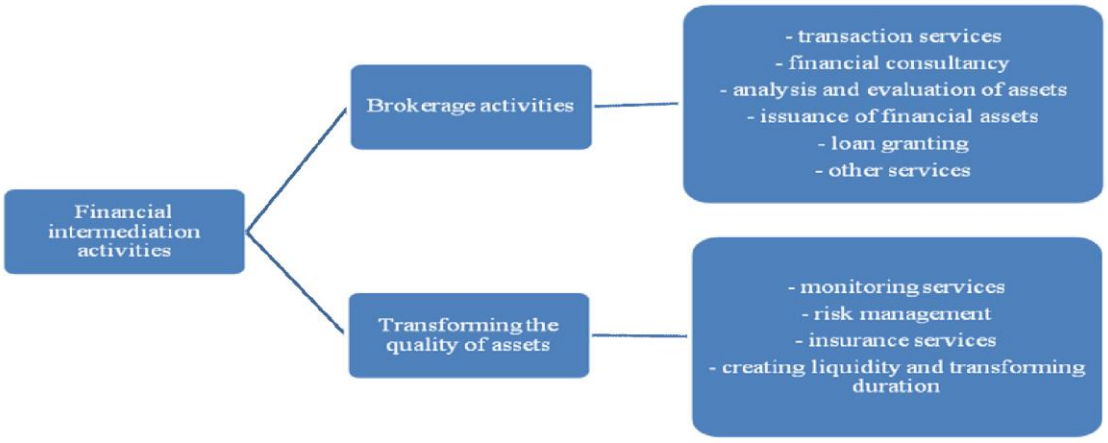


Fig.1 SERVICES RENDERED BY FINANCIAL INTERMEDIARIES

2.2 THEORETICAL REVIEW

2.2.1 THEORY OF FINANCIAL INTERMEDIATION

The theory regarding financial intermediation was developed starting with the 60's in the XX century, the starting point being the work of Gurley and Shaw (1960). The financial intermediation theory is based on the theory of informational asymmetry and the agency theory. In principle, the existence of financial intermediaries is explained by the existence of the following attributable factors: high cost of transaction, inadequate information in useful time; and the method of regulation.

The unique factor in the studies regarding financial intermediation is constituted by the argument regarding informational asymmetry. This asymmetry can be of type: ex ante generating the so called problem of adverse selection; concomitant generating the moral hazard (principal and agent relationship); or ex post leading to the need of applying some costly

verification and auditing procedures or even the forced execution of the debtor. The informational asymmetry generates imperfections of the market, deviations from the theory of perfect markets in an Arrow -Debreu sense. Arrow-Debreu perfect markets synopsis of a near heaven, which depicts that if they is an heaven, then the financial intermediaries would not be useful in the economy at large, but since we are still on earth, it is certain that there will be imperfection and incomplete information which serve has a benefit-cost effect for intermediaries and market.

According to the model of perfect financial markets in the neo -classical theory, they fulfill the following conditions: no one participant can influence the prices; then placement/borrowing conditions are identical for all participants; there are no discriminatory fees; the lack of competitive advantages at the level of participants; all financial securities are homogeneous, dividable and

transactional; there are no transaction costs for obtaining information or of insolvency; all participants have immediate aces to the complete information regarding the factors and elements that can influence the current or future value of the financial instruments.

Many of these imperfections generated by informational asymmetry lead to the emergence of some specific forms of transaction costs. The financial intermediaries have emerged exactly to eliminate, at least partially, these costs. For example, Diamond and Dybvig (1983) consider banks as being a coalition of the depositors that ensures those who save up against the risks that could affect their state of liquidity. Leland and Pyle (1977) define financial intermediaries as a coalitionthat deals with the distribution of information. Diamond (1984) shows that these financial intermediaries action as authorized agents of those who save up and that they can achieve scale economies. Thus those who save up t rust their available funds to these intermediaries in order to be invested in whichever projects they consider viable, the depositors having the possibility to withdraw their funds at any time under the pre -established conditions.

The studies regarding informational asymmetry approach especially the problematic of relationships between bank and creditors, respectively bank and debtors. In the relationship between bank and borrower the main aspect analyzed is the function of the selection bank and the tracking of the granted loans, as well as the problematic of adverse selection and moral hazard. In the relationship between bank and depositors (creditors) a special attention is given to the factors that determine depositors to withdraw their money before due date.

The second approach for the financial intermediation is founded on the argument of transaction cost. This approach was developed by Benston and Smith Jr. (1976) and by Fama (1980). Unlike the first approach this one does not contradicts the theory o f perfect markets. This approach is based on the differences between the technologies used by the participant. Thus intermediaries are perceived as being a coalition of individual creditors or debtors who exploit the scale economy at the level of transaction technologies. The notion of transaction cost does not comprise just the costs regarding the transfer costs for the amounts or of foreign exchange, but also those for research, evaluation and monitoring thus the role of financial intermediaries is to transform the characteristics (due date, liquidity, etc.) of assets, the so called qualitative transformation of financial assets, offering liquidity and opportunities for diversification of placements.

The third approach of financial intermediaries is based on the method of regulation of the monetary creation, of saving and financing of economy. This approach was developed by Guttentag, and Lindsay (1968) and by Merton (1995). The method of regulation influences the liquidity and solvability of intermediaries . Diamond and Rajan (2000) show that the regulations regarding the capital of intermediaries influence their “health”, the ability for refinancing and the method for recovering debts.

2.2.2 INSTITUTIONAL PERSPERCTIVE OF FINANCIAL INTERMEDIAITION.

The financial intermediaries are commercial companies, whose attribute will be the same attribute of firm’s maximization of profit. Through financial engineering prospects should provide products that will bring in or attract surplus unit to deposit funds which will be give out to the the deficits unit a price charged.

However, the main finished products of financial intermediaries are the loans granted to clients, and the main variable inputs are the deposits attracted from the depositors. Furthermore we can regard financial intermediaries as companies that attain their profitability status via the differences between interest perceived for the loans granted and interest abated for the attracted deposits. The profit maximization is made when the difference between the total incomes minus the total costs is maximum, that is when the marginal income is equal to the marginal costs. In order to attract more resources (deposits)

necessary for the increase of the volume of granted loans the financial intermediary must increase the interest paid to depositor(surplus spending unit).The intermediaries in the perspective are characterized by a perfect competition but rather on one with an imperfect competition. This is when the financial intermediaries often give up the profit maximization objective and have the objective of increase in market share.

2.2.3 FUNCTIONAL PERSPECTIVES OF FINANCIAL INTERMEDIATION

In building a financial system, from the scratch one must effectively begin with central theme of effective allocation of resources. Financial intermediaries through their innovation and financial engineering prospects must create assets for creditors and liabilities for debtors which are much more attractive for each of them than if the transfer of funds from creditors to debtors were to be made directly between the two parties. From the primary function of resources allocation, we can further distinguish six core function of financial intermediaries in order to aid economic development and growth posited by Merton (1995) which include

Function 1; A financial intermediary provides a payments system for the exchange of goods and services.

Function 2; A financial intermediary provides a mechanism for the pooling of funds to undertake large-scale indivisible enterprises.

Function 3; A financial intermediary provides a way to transfer economic resources through time and across geographic regions and industries.

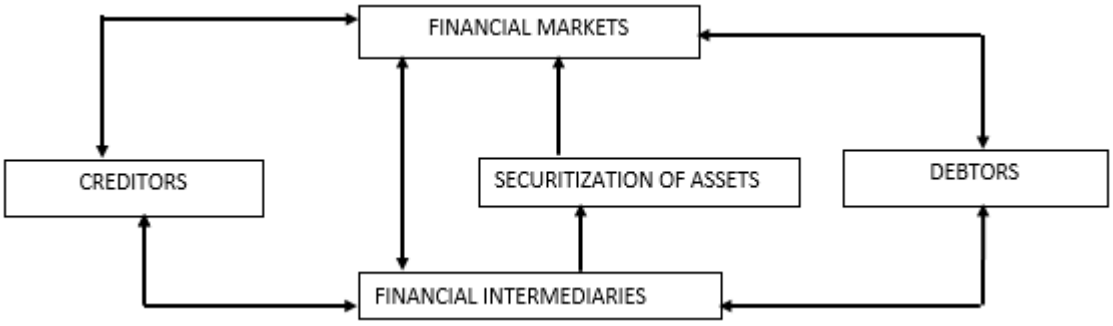
Functions 4; A financial intermediary provides a way to manage uncertainty and control risk, on his behalf and investors behalf.

Function 5; A financial intermediary provides price information that helps coordinate decentralized decision-making in various sectors of the economy.

Function 6; A financial intermediary provides a way to deal with the asymmetric-information and incentive problems when one party to a financial transaction has information that the other party does not.

The analysis of financial institutions as intermediaries implies the analysis of services they offer to clients. The brokerage activity of financial intermediaries entails the bringing together of the two parties with complementary needs, the elimination of informational asymmetry and the performing of the transaction; in order to achieve brokerage activities information is needed. The financial intermediary achieves these activities better than other participants because he has the necessary information, information that is obtained because of his abilities in the interpreting of market signals, unnoticeable for other participants, and of the reuse of the previously obtained information. The financial intermediary presents two competitive advantages: he has special abilities in the interpretation of the signals unnoticeable for other participants and an advantage of the reuse of the information obtained from several clients over a long period of time. The broker is most times reimbursed for the reuse of these services with a certain commission. The characteristics of the assets that are more often transformed by the intermediary are: due date (intermediaries grant long term financings based on the short term resources), the nominal value, liquidity, credit risk, interest rates and measurement unit (the currency the respective asset is in).

This activity implies the undertaking of certain risks by the financial intermediary, the gain of the financial intermediary is made from the difference between the price for which he resells the financial asset and the price for which he purchases it.



2.3 RELATED THEORIES TO FINANCIAL INTERMEDIATION.

- **INFORMATION ASYMMETRY**

The "informational asymmetry" studies focus on the bank/borrower and the bank/lender relation in particular. In bank lending one can basically distinguish transactions-based lending (financial statement lending, asset based lending, credit scoring, etc.) and relationship lending. In the former

class information that is relatively easily available at the time of loan origination is used. In the latter class, data gathered over the course of the relationship with the borrower is used (see Lehman and Neuberger, 2001; Kroszner and Strahan, 2001; Berger and Udell, 2002). Central themes in the bank/borrower relation are the screening and monitoring function of banks (*ex ante* information asymmetries), the adverse selection problem (Akerlof, 1970), credit rationing (Stiglitz and Weiss, 1981), the moral hazard problem (Stiglitz and Weiss, 1983) and the *ex post* verification problem (Gale and Hellwig, 1985). Central themes in the bank/lender relation are bank runs, why they occur, how they can be prevented, and their economic consequences (Kindleberger, 1989; Bernanke, 1983; Diamond and Dybvig, 1983). Another avenue in the bank/lender relationship are models for competition between banks for deposits in relation to their lending policy and the probability that they fulfill their obligations (Boot, 2000; Diamond and Rajan, 2001).

- **TRANSACTION COST**

Transaction costs approach (examples are Benston and Smith, 1976; Campbell and Kracaw, 1980; Fama, 1980). In contrast to the first, this approach does not contradict the assumption of complete markets. It is based on non convexities in transaction technologies. Here, the financial intermediaries act as coalitions of individual lenders or borrowers who exploit economies of scale or scope in the transaction technology. The notion of transaction costs encompasses not only exchange or monetary transaction costs (see Tobin, 1963; Towey, 1974; Fischer, 1983), but also search costs and monitoring and auditing costs (Benston and Smith, 1976). Here, the role of the financial intermediaries is to transform particular financial claims into other types of claims (so-called qualitative asset transformation). As such, they offer liquidity (Pyle, 1971) and diversification opportunities (Hellwig, 1991). The provision of liquidity is a key function for savers and investors and increasingly for corporate customers, whereas the provision of diversification increasingly is being appreciated in personal and institutional financing. Holmström and Tirole (2001) suggest that this liquidity should play a key role in asset pricing theory. The result is that unique characteristics of bank loans emerge to enhance efficiency between borrower and lender. In loan contract design, it is the urge to be able to efficiently bargain in later (re)negotiations, rather than to fully assess current or expected default risk that structures the ultimate contract (Gorton and Kahn, 2000). With transaction costs, and in contrast to the information asymmetry approach, the reason for the existence of financial intermediaries, namely transaction costs, is exogenous.

- **AGENCY THEORY**

In the process of performing their quantitative asset transformation the intermediaries serve as agent to the suppliers of funds, they must maintain the liquidity and profitability status of the stakeholders via monitoring services, risk management, insurance services, creating liquidity and transforming durations .Agency costs are the principal economic dead-weight costs to the intermediary for providing (hedging, capital cushioning ,insuring) remedies in-order to retain assurance of performance of customer's contracts. Diamond and Dybvig (1983) consider banks as being a coalition of the depositors that ensures those who save up against the risks that could affect their state of liquidity. Leland and Pyle (1977) define financial intermediaries as a coalition that deals with the distribution of information. Diamond (1984) shows that these financial intermediaries action as authorized agents of those who save up and that they can achieve scale economies. Thus those who save up trust their available funds to these intermediaries in order to be invested in whichever projects they consider viable, the depositors having the possibility to withdraw their funds at any time under the pre -established conditions.

- **RISK MANAGEMENT THEORY**

Risk Management is the core issue in understanding and explaining the behavior of real-life financial intermediaries. Here we argue that risk management is the core issue in understanding this behavior. Transforming risk for the ultimate savers and lenders and risk management by the financial intermediary itself creates economic value, both for the intermediary and for its clients. Accordingly, it is the transformation and management of risk that is the intermediaries contribution to the economic welfare of the society, it operates in. Banks face a number of risks in order to conduct their business, and how

well these risks are managed and understood is a key driver behind profitability, and how much capital a bank is required to hold. Bank capital consists principally of equity, retained earnings and subordinated debt. Some of the main risks faced by banks include:

- Credit risk: risk of loss arising from a borrower who does not make payments as promised.
- Liquidity risk: risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss (or make the required profit).
- Market risk: risk that the value of a portfolio, either an investment portfolio or a trading portfolio, will decrease due to the change in value of the market risk factors.
- Operational risk: risk arising from execution of a company's business functions.
- Reputational risk: a type of risk related to the trustworthiness of business.
- Macroeconomic risk: risks related to the aggregate economy the bank is operating inThe capital requirement is a bank regulation, which sets a framework within which a bank or depository institution must manage its balance sheet. The categorization of assets and capital is highly standardized so that it can be risk weighted.

However, there are three ways for an intermediary with credit-sensitive activities to provide assurances against default risk to the customers who hold it liabilities;

- By Hedging
- By Insuring
- By Capital cushions

1) By hedging; The firms holds assets that have payouts that "match" those promised on its contractual liabilities, and it chooses a transparent structure so that customers can easily verify that such a matching policy is being followed.

2) By Insuring; The firm acquires guarantees of its customer liabilities from a AAA-credit-rated private sector or government third party. The providing of such guarantees is a large financial-intermediation business, which is itself quite credit-sensitive.

3) By capital cushions; The firm raises additional capital beyond that required for the funding of the physical investments and working capital needed to run the intermediary. included in this category is the common practice of collateralizing contract performance. as for example with repurchase agreements, futures contracts and broker margin loans .The distinctions between the collateral approach and hedging is that the collateral assets are not chosen to match the promised payment obligation on the contract.

2.4 WHY ARE FINANCIAL INTERMEDIARIES REGULATED?

In respect, of the financial innovation (is the engine driving the financial system toward it goal of greater economic efficiency) used by the financial intermediaries in contributing to the technical and absorptive capacity of the economy. If the engine is not lubricated or serviced it may cause havoc to the entire body of the system, so also the financial intermediaries must regulated at times so has to guarantee effectiveness to the household, firms and government.

There are five-categories to classify the paths by which government affects financial intermediation; first, as a ***market participants*** following the same rules for action as other private-sector transactors, such as with open-market operations; second as an ***industry competitor or benefactor of innovation,*** by supporting development or directly creating new financial products or markets, such as securitized mortgages, index-linked bonds, or all-savers accounts; third as both ***legislator and enforcer,*** setting rules and restrictions on financial intermediaries and markets such as minimum-capital rules, asset restrictions, disclosure requirements, margin limits, circuit breakers, and patents on products; fourth as a ***negotiator*** when representing its domestic constituents in dealings with other sovereigns that involve financial intermediaries or markets; fifth, as an ***unwitting intervenor*** who changes general corporate regulations, taxes, and other laws or policies that frequently have significant unanticipated and unintended consequences for the financial-services industry. The reason why this intermediaries are strictly regulated are has follows;

- Due to allocation efficiency, of intermediary the federal government via CBN, reduces the interest rate, so has to encourage proper intermediation of scarce resources.
- The government, through the Central Bank of Nigeria, make sure the household and firm retain their trust in financial institution and intermediaries.
- Efficient and effective payment services, so has to stimulate business transactions in the economy.
- The government must make sure, there is financial development stability in the sector,so has to invite foreign investors
- The government must regulate so has to improve portfolio diversification for investors and corporate governance mechanisms to stimulate agents in organization, in advert of hostile take overs.

2.5 FUNCTIONS OF FINANCIAL INTERMEDIARIES

The theory distinguishes between the following functions of financial intermediaries:

(i) the reduction of transaction costs;

(ii) the reduction of liquidity risk;

(iii) the information provision; and

(iv) the debt renegotiation.

However, the first of these functions concerns the problem of accessibility of financial markets for households/individuals and for firms. The second and the third functions concern the services the banks offer to savers, which cannot be obtained from financial markets.

2.5.1 REDUCTION IN TRANSACTION COSTS

Financial intermediaries transform the credit portfolio demanded by borrowers into a deposit portfolio desired by lenders. This transformation is twofold:

(1) First, financial intermediaries engage in the transformation of terms: firms prefer to finance their projects with long-term credits, and households prefer short -term deposit for liquidity reasons. Financial intermediaries are able to accomplish this transformation, though non -financialfirms could themselves issue instruments like demand deposits or short -term savings contracts.

However, it would be costly for small creditors to write debt contracts with firms (these are complex agreements with restrictive clauses on firm activities). Moreover, small creditors typically like to diversify their risks, which implies greater number of contracts and thus greater transactioncosts. An intermediary is able to exploit economy on scale considerations by writing and enforcing debt contracts with firms. Second, financial intermediaries reduce transaction costs through the payment system. Centralizing this process at the level of financial intermediaries avoids wasteful duplication of verification costs. As Dewatripont and Tirole (1994) note, the vision of banking activities in terms of transaction costs reduction, although relevant, is only incomplete (especially if the issues of control and regulation are concerned), which has stimulated the development of other views regarding bank function. For example, in his famous model of banks as delegated monitors, Diamond (1984) shows that the existence of banks help to avoid the duplication of audit costs on the part of all creditors. The reduction of monitoring costs, though related to the transacti on costs, unveils the information provision function performed by banks. The examples above show the reduction of transaction costs on the side of depositors/creditors. On the side of borrowers/firms, the transaction costs reduction can be seen in the example of financial instrument such as loan commitment. A loan commitment may be considered a financial option, which enables a borrower to obtain a loan at predetermined conditions, and may or may not be exercised. Loan commitments may reduce borrowing rates and eliminate the associated moral hazard problems on the borrower's side. Therefore, the loan commitments provide a possibility for the reduction in transaction costs. At the same time, loan commitments are an example of lending relationships, which provide a basis for debt renegotiation.

2.5.2 LIQUIDITY PROVISION

Depositors (acting as creditors in their relations with financial intermediaries) face liquidity risk in sense of possibility needing liquid funds. The trade -off between liquidity and return forces them to hold their wealth (at least partially) in form of bank deposits. Therefore, models of banks as liquidity providers focus rather on bank liabilities than on bank assets. In

the famous Diamond - Dybvig model, depositors do not know a priori whether they will face liquidity needs in the future. In order to provide depositors, who withdraw their deposits, with liquid assets, banks need to sell less liquid but more profitable assets thereby reducing their profit opportunities. If many depositors withdraw, others are pushed to imitate this behavior, which produces a phenomenon known as bank runs.

Consequently, banks face a dilemma: either to invest in short -term (liquid) assets and not to perform their term-transformation function or to invest (at least partially) in long-term assets and thus face the possibility of bank runs. A solution to this problem is an insured deposit contract, which guarantees the depositors that they get their money back. This prevents the bank runs and suggests an allocation of resources, which is superior to the one without insurance. At the same time, the need of deposit insurance illustrates the necessity of regulatory intervention.

2.5.3 INFORMATION PROVISION

A firm that looks for debt financing typically has a choice between being indebted to the general public or to financial intermediaries. The public debt is inefficient since it forces each lender to assess firm's solvency, or at least to continuously update rating information provided by specialized agencies. This results either in an increase in monitoring costs, or in subnormal monitoring due to free-riding. Gorton and Penacchi (1990) suggest that debt is a less information intensive asset than equity and thus attracts relatively less informed creditors. Given the natural monopoly aspect of information provision, it is logical to presume that the bank debt is more desirable for such creditors than the public debt. A natural monopoly aspect arises here not only because of economies of scale in information provision, but also because of economies of scope since information about a borrower may be obtained by the bank through that borrower's bank account flows.

The information provision function of financial intermediaries is broadly discussed in the literature on information asymmetry, especially when issues of moral hazard and adverse selection are addressed. Diamond (1984) introduced moral hazard in his model to study how crucial information asymmetry is for the bank. In extension of the transaction costs approach, delegated monitoring not only presumes economies of scale (it is socially optimal when the bank monitors the creditors/firms on behalf of depositors), but also answers the question, why the depositors do not need to monitor the bank itself (to monitor the monitor). The mo del shows that the moral hazard problem within the bank decreases when the size of the bank increases, and even completely disappears when the bankholds a fully diversified portfolio of assets.

Hence, if the bank holds a fully diversified portfolio of ass ets, the depositors hold risk-free debt contracts and do not need to monitor the bank (at least, they do not need to monitor the bankcontinuously).

2.5.4 DEBT RENEGOTIATION (QUANTITATIVE ASSET TRANSFORMATION)

If financial markets were frictionless, solvent firms would always have access to funds to raise their capital for new investment opportunities. Microeconomics of asymmetric information suggest some plausible explanations into why friction in the market, such as moral hazard, adverse selection, and/or agency costs create barriers for the flow of capital to firms with profitable investment opportunities. The role of financial intermediaries as information producers, discussed above, provides a solution of this problem. If capital can flow from creditors (depositors) to the borrowers (firms) through the system of financial intermediation, credit contracts between banks and firms should resemble the debt contracts in the market without financial intermediaries.

However, empirical work strongly suggests that bank loans are different from corporate bonds in domestic as well as international capital markets.

Theoretically, in a reputation-lending framework, private creditors deny the future access of sovereign defaulters to capital markets. If a firm defaults on its bonds, it cannot raise additional capital with a new issue of bonds. If such funds can be obtained from banks, firms in financial distress may prefer bank debt to the public debt (bonds).

Diamond (1991) continues to develop his concept of banks as delegated monitors to show why banks can offer loans to firms who can potentially default. Since banks can monitor firms, and the bondholder cannot, the firms can acquire good reputation through borrowing from banks. The firms, who have acquired good reputation can then switch to the bond market to finance their investment.

Bolton and Freixas (2000) stress the relationship aspect of the intermediation. This relationship acts as another kind of commitment: firms know that the banks provide better loan conditions than markets in the times of financial distress. Therefore, firms prefer banks to markets.

Hence, there are at least three reasons, which demonstrate advantages of financial intermediaries in debt renegotiation (compared to markets): (1) the monitoring advantage of the bank, which acts as a punishment instrument, and therefore allows banks to create better provisions for the reputation creation by firms (2) reputation of the financial intermediary as a reliable creditor, which acts as an informal commitment, and (3) the relationship aspect , which also acts as a commitment instrument.

3. CONCLUSION

The structure of financial system of a country, should be a web the will make inter-relationship, between financial institution, financial market and financial instrument easier so has to foster the economic development of the country. The intermediaries are blood line that aid the money creation and money destroying mechanisms, within household, firms and government itself.

Hence, the intermediaries and market should combine the institutional perspective and functional perspective of their function, so has enhance their profitability and enhance accelerated growth, simultaneously.

This vehicle(intermediaries) should be serviced and also lubricated by CBN (Central Bank of Nigeria) at intervals to check their operation or force their operation towards the unified goal of economy they include; moral suasion, direct deposits, open market operation.

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