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The Emerging Role of Financial Intermediaries in the Financial Market of Ghana

Nii Ardey Tagoe*

Export Trade, Agricultural and Industrial Development Fund, ACCRA, Ghana

Abstract

Financial intermediaries at the center of the financial system perform the function of reallocating the surplus resources of household units to other economic units with funding needs. Savers wants to lend on short term and borrowers want to borrow on long term. Financial intermediaries have emerged from the traditional banking to more sophisticated intermediaries such as investment banks, pension funds, venture capital funds, mutual funds and hedge funds due the market imperfection and information asymmetry. This paper discusses the emerging role of financial intermediaries in the financial market in Ghana.

Keywords: Financial intermediaries; Financial market; Banking

Introduction

The intensity of the financial markets in Ghana has grown over the last decade. There are about 447 licensed Microfinance Companies, 28 Universal licensed Banks, 63 Money Lending (Microfinance), 24 Finance Houses, 27 Savings and Loans, 2 Leasing firms, 3 Finance and Leasing firms and 1 Mortgage House in Ghana as at June 2015. The financial market has mostly become markets for intermediaries rather than markets for individuals and firms. This is mainly due to the increased participation cost which means individual withdrawing from the market and relying on intermediaries. Financial intermediaries have become "financial supermarkets" where consumers can obtain a whole range of financial services from the same provider: from investments, advisory and insurance products [1,2]. These intermediaries play a pivotal role in today's credit market.

Background Literature

Ghana's financial sector reforms are a critical part of the country's strategy of achieving emerging market status. The financial system that has emerged is relatively diversified in the range of services and increasingly innovative new products. While small and medium sized private enterprises depend extensively on self-financed capital investments, the economy is dominated primarily by bank-intermediated debt finance. The next stage and the thrust of financial market policy is developing a vibrant capital market as a vehicle for raising funds to support large amounts of equity finance and investment [3].

According to Allen and Santomero [1], the general financial system has been altered over the years in a very complex way. Banks have moved from the role of deposit taking and making loans to firms and consumers to fee-producing activities like annuities, mutual funds, mortgage banking, and insurance brokerage and transaction services. In the last two decades, the share of assets held by banks declines as compared to that of pension funds and investment companies. There has been a growing trend of financial securitization and engineering. Financial intermediaries use sophisticated credit vehicles such as swaps, options and derivatives. Financial transactions in Ghana are getting more complex for average investors to understand. A recent development of a fairly complex financial transaction that went bust is the Ivory Finance-ITAL-SIC credit guarantee bond saga Figure 1.

Most small firms, low wealth individuals, and high wealth individuals do not deal directly with capital and credit market. These identified group of people access the market through financial intermediaries.

Allen and Gale [2] describe the figure above as the emerging paradigm for intermediation and they focussed on one aspect of the emerging paradigm and consider the role of intermediaries in reducing the risk to investors and firms of operating in the new and highly sophisticated markets.

Both Allen and Santomero and Allen and Gale [2] recognises the emerging trends in the role and functions financial intermediaries play in indirect financing. The financial market cannot exist without the financial intermediaries. They both need each other to function effectively.

Analysis

The introduction of foreign banks of international reputation mitigates the anti-competitive disadvantage inherent in concentration

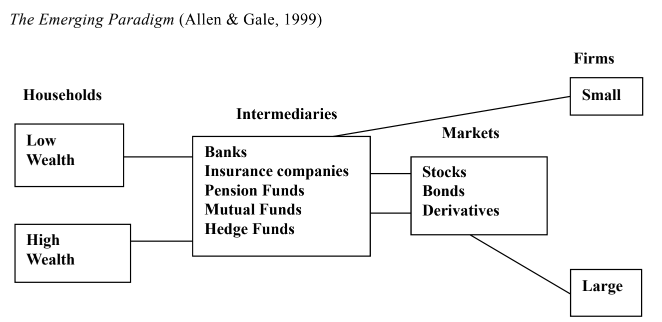

Figure 1: Complex financial transaction.

***Corresponding author:** Nii Ardey Tagoe, Export Trade, Agricultural and Industrial Development Fund, ACCRA, Ghana, Tel: 0302 234668; E-mail: nardtag@gmail.com

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and enhanced market powers of local banks, giving an impulsion to dynamic efficiency. Recent developments in Ghana's banking environment point to the strong foundations for sustainable growth, such as a macroeconomic policy geared towards stability and a structural policy geared towards growth and a sound financial sector.

The most distinctive thing banks do, the essence of their function within the economy, is that they create credit and as a result create spending power [4]. The development of more sophisticated markets has provided a new and somewhat different role for intermediaries. Most households deal with finance houses, mutual funds and insurance companies now more than ever before. Even wealthy investors use private banking service and other finance houses, where advisors make investment decision on behalf of their client. Small and medium firms deal with banks and other intermediaries. Only well established large companies have easy access to the securities markets to finance their activities with the aid of investment banks.

One of the things that discourage small investors and firms from making use of financial markets is the information needed to operate in the volatile and sophisticated market. Investing requires financial expertise that an ordinary investor usually does not possess. Even large firms may lack this expertise. Intermediaries assume the role of advisors, who bridge the gap between the investors' lack of knowledge and the expertise required to get the most out of the markets.

The role of financial intermediary includes increasing returns to scale in executing transactions, monitoring investments and acquiring information. Intermediaries provide information to customers at a lower cost. Small firms and individual investors do not have the skills required and would incur higher cost in to monitor their investment.

Financial intermediaries tailor securities to the needs of individual investors or firms. The market offer opportunity to trade standard securities only. Intermediaries can design securities custom to the needs of the investors. Thus, intermediaries play a crucial role in allowing firms and investors to participate in financial markets and, at the same time, ensure that financial markets have enough depth to survive. In this sense, financial markets and financial intermediaries have a symbiotic relationship. Each is necessary to the other. Without intermediaries, the informational barriers to participation in the market would prevent investors from reaping the benefits of the financial market and the market itself might not survive. Financial markets minimise costs for the intermediaries and their customers and allow them to hedge risks more effectively than they previously could [2].

Financial intermediaries engage in risk sharing. Financial transactions such as derivatives are complex and typically unpredictable. The financial crisis of 2008 was attributed to the sophisticated and high risk taking financial sector. The outstanding derivatives market as at 2003 was $85 trillion. Warren Buffet describes derivatives as financial weapons of mass destruction that could affect not only the parties involved but the whole world economy as a whole [5].

Intermediaries play a crucial role in the financing of small business in the private market. Approximately 80% of venture capital is provided by independent limited partnership venture capital funds with the remainder from other financial intermediaries [6-8].

Conclusions

The Ghanaian financial intermediation has significantly evolved over the last decades. Banks and other financial intermediaries have moved from the traditional functions to more sophisticated financial intermediation in the financial market. According to the World Bank, a strong financial system provides reliable and accessible information with lower transaction cost which boost resource allocation and economic growth.

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