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Assignment number one

Unique number: 651796

Due date: 20 August 2018

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1. Introduction

Financial intermediaries are financial institutions such as the commercial banks, insurance companies or investment banks that offer services to individuals or firms to save or borrow money. A financial intermediary helps to facilitate the different needs of lenders and borrowers.

This essay will discuss the functions of financial institutions as intermediaries i.e. the provision of a payments mechanism, maturity transformation, risk transformation, liquidity provision and reduction of transaction, information and search costs. The main cost advantages of intermediation will also be explained. Firstly, before discussing the functions, financial intermediaries will be defined.

2. What are financial intermediaries?

As the name suggests, financial intermediaries are entities that intermediate between providers and users of financial capital. Financial intermediaries are typically multifaceted, and their activities therefore can be understood from a variety of vantagepoints. For example, contrast to non-financial firms, financial intermediaries hold relatively larger quantities of financial claims as assets. Financial intermediaries, particularly banks, are the most important source of external funds used to finance businesses. Primary source of external funds for businesses throughout the world comprises loans made by banks and other non-bank financial intermediaries.

3. Functions of financial institutions as intermediaries

Financial intermediaries are predominantly concerned with the recycling of funds from surplus to deficit agents; that is, facilitating the transfer of funds from those that wish to save to those that wish to borrow. The most important function of an intermediary is to assist in the transfer of funds from surplus agents to deficit agents and assisting this ✓ process a financial intermediary undertakes several economic functions: the provision of a payment mechanism, maturity transformation, risk transformation, liquidity provision and reduction of transactions, information and search costs.

3.1 Provision of a payments mechanism

Certain financial intermediaries, especially commercial banks, facilitate the payments of funds by non-cash means such as cheques, credit cards, electronic transfers, debit cards and so forth. Increasingly, many of these services are offered by non-bank financial intermediaries that can compete both on price and quality with commercial banks.

3.2 Maturity transformation

A financial intermediary such as a commercial bank typically accepts investors' funds on a short-term basis of less than a year and transforms these liabilities into longer-term assets such as loans. The process of converting short-term liabilities into longer term assets is known as maturity transformation. One of the most important reasons why financial institutions can perform maturity transformation is that they deal with a large number of deficits and surplus agents. The maturity transformation process is vital since it provides both surplus and deficit agents with a greater choice in how to save and borrow funds.

3.3 Risk transformation

In the absence of financial intermediaries, firms might find it very difficult to obtain the risk finance that they require, as savers would be reluctant to put their funds at risk. Financial intermediaries can play an important part in transforming the low-risk requirements of savers into meeting the risk finance requirements of firms. Financial intermediaries can play an important part in transforming the low-risk requirements of savers into meeting the risk-finance requirements of firms. A financial intermediary that receives funds from many surplus agents can pool these funds for on-lending to a large number of deficit agents.

Through this diversification of funds, a financial intermediary can considerably reduce its risk exposures. Effective risk reduction is achieved by making a relatively large number of loans rather than a small number of large loans. In addition, a financial intermediary will tend to lend funds to different sectors of the economy, so that it will not be unduly affected by problems in any particular sector. Financial intermediaries also have their own capital base which provides investors with a protective barrier for their savings should the institution’s activities incur losses.

3.4 Liquidity provision

Surplus agents usually require a high degree of liquidity; that is, the ability to convert their savings in financial assets into money at short notice at low cost and at a fair price. The provision of liquidity is one of the key tasks performed by financial intermediaries and financial markets. Many savings assets, for example corporate and government bonds, have a long term to maturity and in the case of equity no term to maturity. Surplus agents would not be willing to hold these assets unless they also have the ability to on-sell them at short notice at a fair market price.

3.5 Reduction of transaction, information and search costs.

Financial intermediaries provide a convenient place of business for both borrowers and lenders of funds. In addition, financial intermediaries benefit from considerable economies of scale, because they are looking for many prospective investment opportunities, they can devote resources to recruiting and training high-quality staff to assist in the process of finding suitable deficit agents. They draw up standardized contracts and can devote the time and resources to monitoring and enforcing them. Through reducing the search, contracting and information costs, a financial intermediary reduces the costs and risk for surplus agents and also the borrowing costs for deficit agents.

4. The main cost advantages of intermediation

The cost advantages of using financial intermediaries include: reconciling conflicting preferences of lenders and borrowers, risk aversion: intermediaries help spread out and decrease the risks, economies of scale: using financial intermediaries reduces the costs of lending and borrowing and scope: intermediaries concentrate on the demands of the lenders and borrowers and are able to enhance their products and services (use same inputs to produce different outputs).

4.1 Economies of scale

Economies of scale exist because the total cost carrying out a transaction in financial markets increases only a little as the size of the transaction grows. For example, the cost of arranging a purchase of 10, 000 shares of stock is not much greater than the cost of arranging a purchase of 50 shares of stock. The presence of economies of scale in financial markets helps explain why financial intermediaries developed and have become such an important part of our financial structure.

The clearest example of a financial intermediary that arose because of economies of scale is a mutual fund. A mutual fund is a financial intermediary that sells shares to individuals and then invests the proceeds in bonds or stocks. Economies of scale are also important in lowering the costs of things such as computer technology that financial institutions need to accomplish their tasks.

4.2 Risk aversion

The pooling may reduce the individual's risk with respect to loan default if the funds are invested in a diversified portfolio of loans or other investments. Some financial intermediaries specialize in selected types of investments, which gives them a cost advantage in managing such assets. For example, a bank may specialize in credit cards and a mutual fund may specialize in high yielding bonds.

5. Conclusion

Financial intermediaries act as the middleman in financial transactions between two parties i.e. lenders and borrowers. There are several advantages or benefits offered by financial intermediaries. This essay discussed the following functions of financial institutions as intermediaries i.e. the provision of a payments mechanism, maturity transformation, risk transformation, liquidity provision and reduction of transaction, information and search costs. The main cost advantages of intermediation were explained in.

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RESULTS

Total = 20 / 25 (80%)