UNIT 9 FINANCIAL INTERMEDIARIES

Structure

9.0 OBJECTIVES

After going through the Unit, you should be able to:

- define financial intermediation;
- describe the nature and role of financial intermediaries;
- explain the role of deposit insurance;
- discuss how financial intermediation helps in the creation of liquidity; and
- describe the influence of financial intermediation on monetary policy.

9.1 INTRODUCTION

You have learnt about assets and their pricing in the first two Blocks. This Block, as you know, is about financial institutions. The present Unit, the first, in this Block, discusses financial intermediaries. The term financial intermediary may refer to an institution or firm that performs intermediation between two parties in a financial context. The first party is typically the provider of some service or asset, and the second the customer. There are two types of financial intermediaries: banking and non-banking. In this unit we shall study both these types.

We begin by discussing in the next section the nature and role of financial intermediaries. We shall see how they essentially intermediate between possessors of surplus funds (the savers) and those who need funds. Financial intermediaries help to lessen the transaction costs that would arise if the savers and the entities that needed funds were to interact directly and engage in direct finance. In the subsequent section we look at how financial intermediation reduces illiquidity of assets in the economy and enhances liquidity. In the following section, we discuss a method of dealing with a method of protecting the deposits of depositors in financial intermediaries, namely, deposit insurance. In the final section, we look at the way the working of financial intermediaries affects economic activities and variables, and how this is taken into consideration by the central bank while formulating monetary policy. Thus the final section deals with the impact of monetary policies on financial intermediation and the influence of financial intermediaries in the formulation of monetary policy.

9.2 THE NATURE AND ROLE OF FINANCIAL INTERMEDIARIES

In this section we shall explore the nature of financial intermediaries and the role that they play in the economy. Financial intermediaries intermediate between savers and investors. They mobilise savings as well as lend money. Their liabilities are the deposits and funds that investors have placed with them, that is, their liabilities are towards the ultimate savers. Their assets are from loans and the investment in securities that they make. Financial intermediaries obtain funds by issuing financial claims against themselves to market participants, and then investing those funds. The investments that financial intermediaries make can be in the form of loans or securities. These are known as direct investments. You will study this kind of behaviour by banks in the next section. Here, we may give an example of an investment company. An investment company pools the funds of investors and uses those funds to buy a portfolio of securities like stocks and bonds. Investors providing funds to the investment company receive a claim that entitles them to a pro rata share of the outcome of the portfolio. Here the funds provided by the investors to the investment company are called indirect investment. The funds collected by the investment company and used to acquire a portfolio of financial assets constitute direct investment.

The saving-investment process of modern economies is centred on financial intermediation. Financial intermediaries are firms that borrow from consumer/savers and lend to companies that need resources for investment. In contrast, in capital markets investors contract directly with firms, creating marketable securities. The prices of these securities are observable, while financial intermediaries are not visible. One reason why financial intermediaries are important is that the overwhelming proportion of every rupee financed externally comes from banks. Bank loans are the predominant source of external funding in most countries. In almost no country are capital markets a significant source of financing as compared to banks. Equity markets have low significance. As the main source of external funding, banks play important roles in corporate governance, especially during periods of firm distress and bankruptcy. The idea that banks "monitor" firms is one of the central explanations for the role of bank loans in corporate finance. Bank loan covenants can act as monitoring devices, signaling to the bank that it can and should intervene into the affairs of the firm. Unlike bonds, bank loans tend not to be dispersed across many investors. This facilitates intervention and renegotiation of capital structures. Bankers are often on company boards of directors. Banks are also important in producing liquidity. Because bank loans are the main source of external financing for firms, if the banking system is weakened, there appear to be significant real effects.

We will study about banks in the next Unit. In the present one, we discuss financial intermediaries in general.

The main role of financial intermediaries is in reducing transactions costs and asymmetric information in financial markets. Two other functions that financial intermediaries perform are that they facilitate in transfer of risk, and they help in providing service in terms of making participation in capital markets easy by simplifying the dealing with a complex maze of assets and instruments, which, in the absence of financial intermediaries, participants would find very difficult. Intermediation theory has suggested that it is frictions such as transaction costs and asymmetric information that are important in understanding intermediation. Gurley and Shaw and many subsequent authors have stressed the role of transaction costs. For example, fixed costs of asset evaluation mean that intermediaries have an advantage over individuals because they allow such costs to be shared. In the same way, trading costs mean that intermediaries can more easily be diversified than individuals. Investors do not usually have complete information about financial markets and their information sets are thus not complete. This leads to the creation of considerable transaction costs and friction. Some experts have suggested that since intermediaries have greater information than investors, an intermediary can signal its informed status to the investors by itself investing its wealth in assets about which it has special knowledge. Diamond has suggested that intermediaries overcome asymmetric information problems by acting as "delegated monitors."

In recent years the financial systems in many countries have undergone a dramatic transformation. Financial markets such as the stock and bond markets have grown in size and volumes traded. Simultaneously, there has been extensive financial innovation, which has accelerated in recent decades. This includes the introduction of new financial products, such securitised assets, as well as derivative instruments such as swaps and complex options. These have all grown tremendously in volume. At the same time, new exchanges for financial futures, options and other derivative securities have appeared and become major markets. The importance of different types of intermediary over this same time period has also undergone a significant change. Mutual funds and pension funds have grown tremendously in scope while the growth of insurance companies has not been to the same extent. New types of intermediary such as non-bank financial firms like GE Capital have emerged which raise money entirely by issuing securities and not at all by taking deposits. In short, traditional intermediaries have declined in importance even as the sector itself has been expanding. Perhaps the most important change in intermediaries' activities that has occurred in the last thirty years is the growth in the importance of risk management activities undertaken by financial intermediaries. The change in the breadth of the markets that are available for hedging risk has not led very many individual or corporate customers to manage their own risk. Rather, it has meant that risk management has now become a central activity of many intermediaries.

The interesting thing is that this increase in the breadth and depth of financial markets has been the result of increased use of these instruments by financial intermediaries and firms. They have not been used by households to any significant extent. In fact, the increased size of the financial market has coincided with a dramatic shift away from direct participation by individuals in financial markets towards participation through various kinds of intermediaries. This is another important role the intermediaries play, that of expanding the financial markets by themselves participating.

Check Your Progress 1

1) Distinguish between banking and non-bank financial intermediaries.

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2) What important role do financial intermediaries play in the economy?

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3) What changes are taking place in financial markets in recent years? What role is being played by financial intermediaries in this change?

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9.3 ILLIQUID ASSETS AND THE CREATION OF LIQUIDITY

Financial intermediaries provide the link between the financial and the real sector. Financial intermediaries perform the roles of resource mobilisation and allocation, risk diversification and liquidity management to foster development of the real sector.

In a complete information deterministic world also, financial intermediaries can have the important role of a temporary resource provider when there is a time lag between the firms' factor payments and receipts from sale proceeds. This role becomes more significant when the firms do not have enough resources of its own to cover its factor payments and the financial intermediaries come in and provide working capital finance.

In this section, we shall be dealing with the working of financial intermediaries and the quantum of liquidity in the system. The existence of a secondary market for a financial asset increases the asset's liquidity. Do financial intermediaries change the distribution of assets such that illiquid assets are reduced in number and the liquidity goes up? Or does the presence of financial intermediaries lead to displacement from the total stock of money in the economy? To answer these we must look at the relationship among credit financial assets and saving

In the various types of assets that constitute the wealth of a person or a nation, some assets like physical assets are not relevant to the pace of spending on goods and services. Others are relevant to a varying degree. Money is the most relevant asset in this regard. The greater such relevance, the closer is that asset to money and the more liquid it is. The basic characteristic common to all financial intermediaries—banking and non-banking—is that while by their operations they do not add to the stock of total wealth, they add to the liquidity of the economy by putting into the hands of potential spenders assets (liabilities of the financial intermediaries) that are more liquid than the assets (which include promises to repay) that these financial intermediaries take in exchange. The occurrence of this process leads people to say that financial intermediaries create credit. It is also why it is said that financial intermediaries perform the useful function of mobilising saving for development, making these savings available for the financing of investment in physical capital in the economy.

The financial intermediaries accept various claims on other people (when these financial intermediaries lend) and offer their own claims: claims against themselves (when people keep their deposits with them). Customers deal with them because the liabilities of the financial intermediaries are more attractive than the liabilities of the customers themselves. The operations of financial intermediaries are exchanges of claims. The essential nature of 'credit creation' is the increase in market effectiveness because people have a high degree of confidence in financial intermediaries. This creation of credit is in the exchange of more marketable claim for a less exchangeable claim. In this respect, financial intermediaries have some influence on general economic processes. The activities of financial intermediaries are, as we have seen, related to saving and investment processes. Thus credit creation gets linked to the saving and investment processes. This is how financial intermediaries substitute, by exchanging claims, less liquid assets by more liquid ones and increase the liquidity in the economy.

9.4 THE ROLE OF DEPOSIT INSURANCE

Deposit insurance is a measure taken by banks in many countries to protect their clients' savings, either fully or in part, against any possible situation that would prevent the bank from returning said savings. Deposit insurance institutions are for the most part government run or established, and may or may not be a part of a country's central bank. The USA was the first country to establish an official deposit insurance scheme, during a banking crisis in 1934 during the Great Depression

Deposit insurance, as we know it today, was introduced in India in 1962. India was the second country in the world to introduce such a scheme – the first being the United States in 1933. Banking crises and bank failures in the 19th as well as the early 20th Century (1913-14) had, from time to time, underscored the need for depositor protection in India. After the setting up of the Reserve Bank of India, the issue came to the fore in 1938 when the Travancore National and Quilon Bank, the largest bank in the Travancore region, failed. As a result, interim measures relating to banking legislation and reform were instituted in the early 1940s. The banking crisis in Bengal between 1946 and 1948, once again revived the issue of deposit insurance. It was, however, felt that the measures be held in abeyance till the Banking Companies Act, 1949 came into force and comprehensive arrangements were made for the supervision and inspection of banks by the Reserve Bank.

It was in 1960 that the failure of Laxmi Bank and the subsequent failure of the Palai Central Bank catalyzed the introduction of deposit insurance in India. The Deposit Insurance Corporation (DIC) Bill was introduced in the Parliament on August 21, 1961 and received the assent of the President on December 7, 1961. The Deposit Insurance Corporation commenced functioning on January 1, 1962.

The Deposit Insurance Scheme was initially extended to functioning commercial banks. Deposit insurance was seen as a measure of protection to depositors, particularly small depositors, from the risk of loss of their savings arising from bank failures. The purpose was to avoid panic and to promote greater stability and growth of the banking system – what in today's argot are termed financial stability concerns. In the 1960s, it was also felt that an additional the purpose of the scheme was to increase the confidence of the depositors in the banking system and facilitate the mobilisation of deposits to catalyst growth and development.

When the DIC commenced operations in the early 1960s, 287 banks registered with it as insured banks. By the end of 1967, this number was reduced to 100, largely as a result of the Reserve Bank of India's policy of the reconstruction and amalgamation of small and financially weak banks so as to make the banking sector more viable. In 1968, the Deposit Insurance Corporation Act was amended to extend deposit insurance to 'eligible co-operative banks'. The process of extension to cooperative banks, however took a while it was necessary for state governments to amend their cooperative laws. The amended laws would enable the Reserve Bank to order the Registrar of Co-operative Societies of a State to wind up a co-operative bank or to supersede its Committee of Management and to require the Registrar not to take any action for winding up, amalgamation or reconstruction of a co-operative bank without prior sanction in writing from the Reserve Bank of India. Enfolding the cooperative banks had implications for the DIC - in 1968 there were over 1000 cooperative banks as against the 83 commercial banks that were in its fold. As a result, the DIC had to expand its operations very considerably.

The 1960s and 1970s were a period of institution building. 1971 witnessed the establishment of another institution, the Credit Guarantee Corporation of India Ltd. (CGCI). While Deposit Insurance had been introduced in India out of concerns to protect depositors, ensure financial stability, instill confidence in the banking system and help mobilise deposits, the establishment of the Credit Guarantee Corporation was essentially in the realm of affirmative action to ensure that the credit needs of the hitherto neglected sectors and weaker sections were met. The essential concern was to persuade banks to make available credit to not so creditworthy clients.

In 1978, the DIC and the CGCI were merged to form the Deposit Insurance and Credit Guarantee Corporation (DICGC). Consequently, the title of Deposit Insurance Act, 1961 was changed to the Deposit Insurance and Credit Guarantee Corporation Act, 1961. The merger was with a view to integrating the functions of deposit insurance and credit guarantee prompted in no small measure by the financial needs of the erstwhile CGCI.

After the merger, the focus of the DICGC had shifted onto credit guarantees. This owed in part to the fact that most large banks were nationalised. With the financial sector reforms undertaken in the 1990s, credit guarantees have been gradually phased out and the focus of the Corporation is veering back to its core function of Deposit Insurance with the objective of averting panics, reducing systemic risk, and ensuring financial stability.

To start reviewing the problem of why deposit insurance exits, one should first elucidate the functions (services) of the modern banking firms. Since the work of Gurley and Shaw in 1960, economists have viewed banks and other financial institutions as intermediaries that perform special functions while channelling credit from economic agents with excessive funds to economic agents with fund shortages.

Check Your Progress 2

1) Do financial intermediaries help in the creation of liquidity? Give reasons for your answer.

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2) Explain the concept of deposit insurance.

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3) Briefly describe the evolution of deposit insurance in India.

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9.5 FINANCIAL INTERMEDIATION AND MONETARY POLICY

To conduct monetary and fiscal policies successfully, policy makers must have an accurate assessment of the timing and effects of their policies on the economy. This includes an understanding of the monetary transmission mechanisms through which monetary policy affects the decisions of firms, households, financial intermediaries and investors that influence the level of economic activity and prices. Monetary policy primarily looks at influencing the stock of money supply in the economy, and includes policies with regard to credit and interest rates.

Current theories of the economic role of financial intermediaries build on the economics of imperfect information that began to emerge during the 1970s. There is a view that financial intermediaries can be ignored because they have no real effects. They constitute a veil. They do not affect asset prices or the allocation of resources. Others feel that the savings-investment process, the workings of capital markets, corporate finance decisions, and consumer portfolio choices cannot be understood without studying financial intermediaries.

We have seen that financial intermediaries deal in financial claims. A financial claim becomes attractive to holders because of a combination of security, exchangeability and interest rates. Some claims are attractive for some factor, some for other factors. a change in the rate of interest changes the relative attractiveness of one financial claim as compared to others. People can adjust their portfolio of assets in response to such a balance of attractiveness. If interest rates rise, they will make such adjustment leave the structure of financial claims less skewed in favour of the exchangeability factor. The opposite is the case if interest rates have fallen. These changes are independent of the changes in nominal national income. A rise interest rates will lead to the fall in the stock of money stock (for example bank deposit) relative to national income, that is, a rise in the income velocity of circulation. This interdependence of the structure of financial claims, the level of interest rates and the flow of money income, leads to a link between financial intermediation on the one hand and monetary and interest rate policy on the other. Additionally, financial intermediaries can create credit, and, as you will read in the next unit, banks can add to the stock of money and thus add to the money supply, and therefore, monetary policy seeks to influence the amount of bank lending, and does this by controlling the proportion of reserves that banks are required to keep as cash, as well as by influencing the interest rates in the economy.

Check Your Progress 3

1) In what way can we see that financial intermediaries create credit?

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2) Explain the channel through which financial intermediation can be influenced by monetary policy.

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9.6 LET US SUM UP

In this Unit we discussed the very important activity of intermediation in the financial world. We discussed a class of special institutions called financial intermediaries. These mediate between entities with surplus funds and those who need these funds. The Unit discussed the economic processes behind the working of financial intermediaries. We saw that there are two types of financial intermediaries, banking and non-banking.

Financial intermediaries as a whole perform the basic function of transforming financial assets acquired through the market and constituting them into a different, more preferable type of assets, which becomes their liabilities. We then went on to look at how financial intermediaries help in the creation of liquidity and help to transform illiquid assets into liquid ones. After this, the concept of deposit insurance was discussed, and the development of deposit insurance scheme in India was taken up. Finally, the very important topic of monetary policy was taken up. It was observed that banking financial intermediaries create money through the process of lending. Because of this, and also because of general functions of the financial intermediaries, it was observed that there is a close two-way link between financial intermediaries and the monetary policy by the Central bank. This link was explored and discussed.

9.7 KEY WORDS

Depository Institutions : These are institutions which accept funds from individuals and use these to participate in the debt market.

Disintermediation : Phenomenon of depositors withdrawing funds from financial intermediaries in favour of direct finance.

Financial Intermediaries : These are institutions through which savers can indirectly provide funds to borrowers.

Illiquidity of a Bank : A bank is illiquid if it lacks enough liquid assets to meet the immediate demands of its creditors and debtors.

Indirect Finance : Iindirect finance involves the presence of an intermediary between borrower and lender.

Symmetric Information : Applied to debt markets, it means a situation when borrowers and banks have the same information about whether a loan will be repaid.

9.8 SOME USEFUL BOOKS

Benton, E.G., (1976) *Financial Intermediaries, An Introduction*, Houghton, Boston

Bhole, L.M., (2004) *Financial Institutions and Markets*, 4th edition, Tata-McGraw-Hill, New Delhi.

Johnson, H.J., (1993) *Financial Institutions and Markets*, McGraw-Hill, New York.

Neave, Edwin, (1998) *Financial Systems: Principles and Organisation*, Routledge, London.

9.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See Section 9.2 and answer.
2) See Section 9.2 and answer.
3) See Section 9.2 and answer.

Check Your Progress 2

1) See Section 9.3 and answer.
2) See Section 9.4 and answer.
3) See Section 9.4 and answer.

Check Your Progress 3

1) See Section 9.5 and answer.
2) See Section 9.5 and answer.