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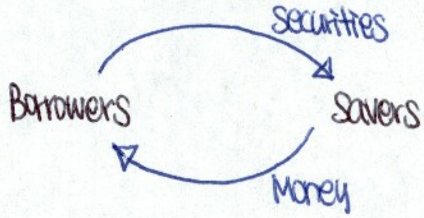
- Why financial intermediaries need/exist?

  → middle person to connect borrowers and lenders (savers)

Before we answer this question, let's think about this: how is capital transferred between borrowers and savers?

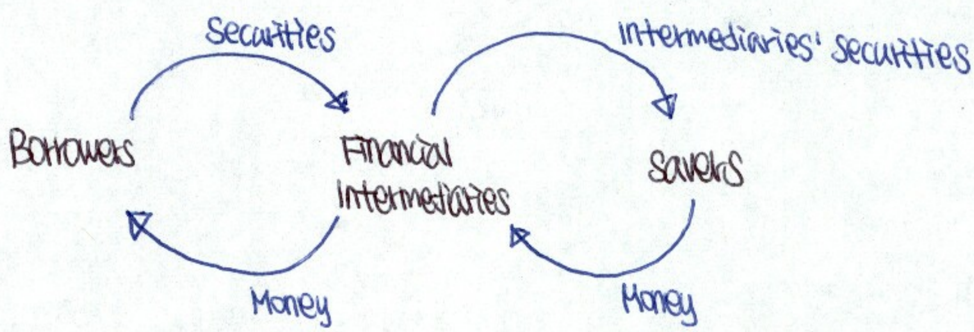
① * Direct transfer (without financial intermediaries)



* Problems?

⇒ with low level of funds flows between borrowers and savers, monitoring costs, liquidity costs and price risk rise substantially!

② *** Financial intermediaries



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ⓐ Financial intermediaries provide liquidity to savers.

ⓑ Financial intermediaries are less risky than lending directly.

ⓒ Financial intermediaries are better able to judge the quality of borrowers and monitor the loans more effectively once it is disbursed. (economies of scale)

- Examples/Types of Financial intermediaries? ① Commercial banks, ② investment banks, ③ mutual funds, ④ pension funds, ⑤ insurance companises...

① Commercial banks usually accept deposits from the public and lend money to businesses/individuales.

② Investment banks generally do not accept deposits from the public and make loans to businesses/individuals. They underwrite debt and equity issues, and sell those offerings to investors.

③ mutual funds are pool investor funds to financial instruments and thus reduce risks through diversification.

④ pension funds are retirement plans funded by corporations or government agencies. They generally consist of stocks, bonds, and real-estate.

⑤ insurance companies also facilitate/help/connect borrowers to savers.

- The primary signaling mechanism for the movement of money between borrowers and savers is * interest rates (≈ the price of credit).
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  ① when capital is scarce, interest rates will increase and capital will flow to the most productive sectors of an economy.

  ② when capital is abundant, interest rate will decrease and spur borrowing, thereby increasing economic activities.

- * Too Big to Fail?

"Too Big to Fail" defined as the reluctance of governments and central banks to allow big banks to fail because of its widespread impact on the rest of the economy. The impact is stronger if the financial institutions are interconnected and the failure of one bank results in the failure of many other banks. The largest multinational banks are interconnected globally and their failures can trigger a global recession, as evidenced in the 2008 financial crisis. The * Dodd-Frank Act of 2010 addresses this issue of "Too Big to Fail" by attempting to reduce the proability of large banks failing.

※ Please read Financial Management Notes - 2. Financial Markets and Institutions.