

Class: FY BSc

Subject : Financial Markets

Subject Code: PUSOE108

Chapter: Unit 3 Chapter 1 and 2

Chapter Name: Role, types of functions of financial intermediaries

Today's Agenda

1. Definition and Concept
2. Role of financial intermediaries
3. Types of financial intermediaries
4. Well functioning financial system

1 Definition and Concept



What according to you are financial intermediaries and what is their importance?

1 Definition and Concept

Overview

A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment bank, mutual fund, or pension fund.

Financial intermediaries offer a number of benefits to the average consumer, including safety, liquidity, and economies of scale involved in banking and asset management.

Although in certain areas, such as investing, advances in technology threaten to eliminate the financial intermediary, disintermediation is much less of a threat in other areas of finance, including banking and insurance.

Financial intermediaries move funds from parties with excess capital to parties needing funds. The process creates efficient markets and lowers the cost of conducting business. For example, a financial advisor connects with clients through purchasing insurance, stocks, bonds, real estate, and other assets. Banks connect borrowers and lenders by providing capital from other financial institutions and from the Federal Reserve. Insurance companies collect premiums for policies and provide policy benefits. A pension fund collects funds on behalf of members and distributes payments to pensioners.

2 Role of financial intermediaries

Financial intermediaries play crucial roles in the economy by facilitating the flow of funds between savers and borrowers. Here are the key roles of financial intermediaries:

Mobilizing Savings: Financial intermediaries collect savings from individuals, households, and businesses in the form of deposits, premiums, or contributions to investment funds. They aggregate these small amounts of funds into larger pools, making them available for lending and investment.

Allocating Funds: Once savings are collected, financial intermediaries allocate these funds to various borrowers, including individuals, businesses, governments, and other entities. They evaluate investment opportunities, assess risks, and allocate funds to projects or investments with the potential for the highest returns.

Providing Credit: Financial intermediaries provide credit to borrowers in the form of loans, mortgages, and credit lines. By extending credit, intermediaries facilitate consumption, investment, and economic growth. They also play a crucial role in allocating credit efficiently by directing funds to productive uses.

2 Role of financial intermediaries

Risk Management: Financial intermediaries help manage and mitigate various types of risks, including credit risk, interest rate risk, liquidity risk, and market risk. They diversify their portfolios, monitor credit quality, and employ risk management techniques to protect depositors' funds and investors' capital.

Facilitating Payments: Intermediaries facilitate transactions and payments between economic agents by providing payment services such as checking accounts, electronic funds transfers, and debit/credit cards. They ensure the smooth functioning of the payment system, enabling businesses and individuals to engage in commerce efficiently.

Providing Liquidity: Financial intermediaries enhance market liquidity by offering liquid assets that can be easily bought or sold without significantly affecting their prices. They create secondary markets for financial instruments, allowing investors to buy and sell securities with ease, thereby improving market efficiency.

2 Role of financial intermediaries

Offering Financial Services: Financial intermediaries offer a wide range of financial services, including investment management, wealth management, insurance, and financial advisory services. They help individuals and businesses achieve their financial goals, manage risks, and plan for the future.

Intermediation and Information Processing: Financial intermediaries serve as intermediaries between savers and borrowers, processing information, and reducing information asymmetry. They conduct due diligence, assess creditworthiness, and provide information to investors and borrowers, facilitating informed decision-making.

Promoting Economic Growth: By mobilizing savings, allocating funds efficiently, providing credit to productive investments, and offering financial services, intermediaries contribute to economic growth and development. They play a vital role in capital formation, resource allocation, and the efficient functioning of financial markets.

3 Types of financial intermediaries



What all types of financial intermediaries can you think of?

3 Types of financial intermediaries

Brokers:

- Agents who fill orders for their clients, helping to reduce their client's transaction costs by efficiently matching them with someone else willing to take the other side of their trades.
- A broker can also refer to the role of a firm when it acts as an agent for a customer and charges the customer a commission for its services

3 Types of financial intermediaries

Types of brokers:

- **Discount brokers** execute trades on behalf of a client, but typically don't provide investment advice. Late in 2019 many discount brokers made a significant shift in their business model that included charging no commissions on some or all of their equity trades. Examples of some discount brokers include Fidelity, Charles Schwab, E-Trade, Interactive Brokers and Robinhood.
- **Full-service brokers** provide execution services as well as tailored investment advice and solutions. Examples of a full-service broker might include offerings from a company such as Morgan Stanley or Goldman Sachs or even Bank of America Merrill Lynch. Such companies may also use their broker services on behalf of themselves or corporate clients to make large block equity trades.
- **Block brokers** deal only in large orders. Block brokers serve to manage large orders in such a way that their clients lose the least amount of money due to adverse movements in the market.

3 Types of financial intermediaries

Investment banks:

- It primarily helps corporate clients in issuing a wide range of securities, including common stock, preferred stock, notes, and bonds in addition to assisting their clients with potential takeover targets. Example: Axis Bank Ltd, Barclays Bank PLC and many others.

Exchanges:

- They provide places where traders can meet to arrange their trades. The distinction between brokers and dealers and exchange has blurred recently because exchanges can act as brokers. The distinguishing features of exchanges are the existence of listing regulation and financial disclosures. Example: The Indian Exchanges - NSE and BSE.

3 Types of financial intermediaries

Arbitrageurs

- They make a profit from market imperfections. Even if pure arbitrage does not exist, arbitrageurs use valuation relationships between financial instruments based on the same underlying to identify arbitrage opportunities.

Dealers:

- They trade with their clients either on an exchange or through a computerized network. They buy securities when the client wants to sell them and vice versa. They differ from brokers in that brokers do not trade with clients

3 Types of financial intermediaries

Securitizers:

They issue securities that are backed by a pool of assets such as mortgages, credit card debt, etc. through a process called securitization.

Asset-backed securities benefit from diversification, economies of scale in debt services and liquidity.

Example: It is interesting to note that the ICICI Bank has emerged as the biggest institution dealing in securitization. It commands 40 percent of the securitization transactions amounting to Rs. 1929.9 crore backed by its new and old car loans

3 Types of financial intermediaries

Depository institutions

- It includes commercial banks, savings and loan banks, credit unions, and similar institutions that raise funds from depositors and other investors and lend it to borrowers. Depositors benefit from the banks' transaction services and interest payments on their deposits while the bank benefits by obtaining funds without finding and raising capital from investors..

Insurance Companies:

- They help individuals and companies offset the risks they want to avoid in exchange for a premium. Insurers are able to offer risk mitigation at a low cost due to diversification. Example: ICICI Lombard General Insurance, Bajaj Allianz General Insurance.

3 Types of financial intermediaries

Clearing House:

A clearinghouse is an exchange that facilitates settlement of contracts. It allows only its members to trade. Depositories or custodians hold securities on client's behalf.

For Example, In India, the capital market regulator SEBI has said that National Securities Clearing Corporation Ltd (NSCCL), Indian Clearing Corporation Ltd (ICCL) and MCX-SX Clearing Corporation Ltd (MCX-SXCCL) are the only qualified central counterparties (QCCPs) in the Indian securities market.

The three corporations clear and settle trades in securities or other instruments/ products traded on the stock exchange.

3 Types of financial intermediaries

Mutual Funds:

A mutual fund is an investment option where money from many people is pooled together to buy a variety of stocks, bonds, or other securities. This mix of investments is managed by a professional money manager, providing individuals with a portfolio that is structured to match the investment objectives stated in the fund's prospectus.

Pension Funds:

A pension fund is a fund that accumulates capital to be paid out as a pension for employees when they retire at the end of their careers. Pension funds typically aggregate large sums of money to be invested into the capital markets, such as stock and bond markets, to generate profit (returns).

A pension fund represents an institutional investor and invests large pools of money into private and public companies. Pension funds are typically managed by companies (employers). The main goal of a pension fund is to ensure there will be enough money to cover the pensions of employees after their retirement in the future.

4 Well-functioning financial system

A well-functioning financial system has complete markets with effective financial intermediaries and financial instruments allowing:

- Investors to move money from the present to the future at a fair rate of return;
- Borrowers to easily obtain capital;
- Hedgers to offset risks; and
- Traders to easily exchange currencies and commodities.

Characteristics:

- Well-functioning financial systems are characterized by financial instruments that help to solve financial problems, liquid markets with low trading costs, timely financial disclosures resulting in market prices that reflect available information, and therefore prices that move primarily with changes in fundamental value instead of liquidity demands.
- Well-functioning markets ultimately lead to efficient allocations, which use resources where they are most valuable.