Lecture 2.
Role and types of financial intermediaries

International finance and globalization

Why do financial intermediaries exist?

In order to overcome **market imperfections**:

1. Differences in preferences of lenders and borrowers
2. Transaction costs
3. Asymmetric information

Asset transformation

1. **Maturity transformation:** banks make long-term loans and fund them by issuing short term deposits
2. **Size transformation:** FIs collect the small amounts of funds from lenders and parcel them into the larger amounts required by borrowers
3. **Liquidity transformation:** FIs provide deposit contracts with high liquidity and offer loans that are instead are illiquid
4. **Risk transformation:** FIs provide deposit contracts with low risk, while loans still bear a higher risk

Asset Transformation

Households Deposits are:

1. Short-term (<1-2 Y)
2. Small-size
3. Liquid (easy to withdraw)
4. Riskless

Firms Loans are:

1. Long-term (<3-5 Y)
2. Large-size
3. Illiquid (hard to withdraw)
4. Risky

How do they solve this?

- ✔ **Screening loan applications:** select "good borrowers" by usage of collected informational sources
- ✔ **Diversifying risk:** avoid high concentration of borrowers by lending to different types of borrowers
- ✔ **Pooling risks:** reduce variability of losses by the presence of large number of loans

Transaction costs (SOME costs)

- **Search costs:** costs of searching out, and finding information about, a suitable counterpart (incurred both by lenders and borrowers).
- **Observing information** (Verification costs): lenders incur costs to verify the accuracy of the information provided by borrowers.
- **Monitoring and auditing costs:** once a loan is made, lenders incur costs to monitor the activities of borrowers, and their adherence to the conditions of the contract.
- **Enforcement costs:** in case the borrower is unable to meet the conditions of the contract, the lender will need to ensure their enforcement.

How do they solve this?

- ✔ **Economies of scale:** reduction in transaction costs per dollar of output as the size (scale) of the financial transaction increases
- ✔ **Economies of scope:** cost advantage to producing more than one product/service jointly rather than producing them separately
- ✔ **Expertise:** expertise in information technology (e.g. ATM, automated teller machines, or POS, point of sales) aimed at providing low-cost liquidity services

Asymmetric information

1. **Adverse Selection**
   - Type of a potential borrower is unknown
   - Bad borrowers most actively seek out loans, even under worse conditions
   - Good borrowers cannot afford worse conditions

How do they solve this?

- ✔ **Expertise in information production**
- ✔ **Private negotiations about interest rate**
- ✔ **Collateral**

2. **Moral hazard (Principal-agent problem)**

Borrower may engage in activities that are undesirable (immoral) for the lender. These activities potentially reduce the probability that the loan will be repaid.

- ✔ **Venture capital** (put people in management in case of investment)
- ✔ **Reputation effect**
- ✔ **Restrictive covenants**
- ✔ **Monitoring and enforcement**

Banks

Central banks

- provide regulatory services
- lend to other banks
- collect reserves
- control the amount of money in circulation
- act as a lender of last resort

Commercial banks

Retail banks
(individuals and small- or medium-sized businesses)
- checking and savings accounts
- mortgages, auto loans and other lending
- cashier's checks, ATM access
- credit cards and debit cards
- safe-deposit boxes

Corporate (Wholesale) banks
(big companies, other banks, government agencies and large institutions such as colleges, charities or pension funds)
- retail-type services
- cash-management services
- leases for vehicles and equipment and others

Investment banks

Investment banks
provide consulting and strategic services to firms
- Corporate underwriting (IPO,SPO)
- Mergers and Acquisitions(M&A)

Private banks/Wealth management
provide brokerage services and advisory on markets investments

Public markets

Hedge fund

Limited number of investors

Work with any instruments, shorts and derivatives

Mutual fund

Unlimited number of investors

Work within specific strategy:

1. Money market
2. Fixed income
3. Equity
4. Balanced
5. Index
6. Speciality
7. Fund-of-funds

Pension fund

Provide **retirement** income

Work with low risk securities (blue chips)

Private markets (pre-IPO)

Venture Capital

Invest and manage **start-ups**

Private Equity

Invest and manage **more mature undervalued firms**

Essential reading for Lecture 2:

1. Buckle, M. and E. Beccalli Principles of banking and finance (UOL study guide) **pp. 18-26, 65-72 (exclude Liquidity needs), 73-76 (exclude A theory of financial intermediations …), 77-80, 82-86**

2. Mishkin, F. and S. Eakins *Financial Markets and Institutions.* (Addison Wesley) **Chapter 7, 8**